The U.S. Economy in Transition

Federal Reserve System. Board of Governors.

A Prelude to the Annual Report for 1970

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Introduction

Economic and financial conditions in the United States during 1970 were in a difficult transitional stage. Real output was stagnant and unemployment was rising, and at the same time prices continued upward under continued cost pressures. Meanwhile, the balance of payments was affected by adverse shifts in capital flows, as a sharp drop in short-term interest rates in this country led to a reversal of the very large inflow of short-term capital that had contributed to surpluses in the U.S. official settlements balance in the previous 2 years.

Substantial progress was made during 1970, however, in re-establishing the basis for sustainable economic expansion. Although wage increases—particularly under collective bargaining agreements—continued to be large, resumption of growth in productivity after the first quarter served to moderate the rate of increase in unit labor costs. The gains in efficiency that were effected in the business sector also worked toward an improvement in the international competitive position of the United States.

The financial positions of key spending sectors also improved in 1970. The position of corporations generally was bolstered by further heavy long-term borrowing and some restructuring of balance sheets in the direction of greater liquidity. As to consumers, their savings in liquid forms were considerably enlarged, to some extent as a result of their cautious spending behavior throughout the year; and financial positions were also favorably affected later in the year as the recovery in the stock market in the second half offset a large part of the earlier price declines.

Financial markets too moved into a position more compatible with sustainable, long-term economic growth. By early 1971 conditions in these markets had eased substantially. Interest rates were considerably lower, banks and other financial institutions were more liquid, and the volume of funds available to borrowers was much improved as compared with the situation a year earlier. Part of this easing in financial conditions reflected a moderation in private borrowing needs stemming from slower growth in current-dollar gross national product and a leveling off in the capital expenditures of business, which earlier had been running far ahead of internally generated funds.

But more important was the resumption in 1970 of growth at moderately high rates in such monetary aggregates as the money stock and bank credit—an expansion that became feasible and desirable because excess demand had been eliminated. Broader measures of liquidity showed relatively more rapid growth than the narrowly defined money stock (currency plus demand deposits other than interbank and U.S. Government). With yields on market securities declining, interest rates paid on time and savings deposits became progressively more attractive, and such deposits expanded sharply at both commercial banks and at other savings institutions. For commercial banks, time deposit expansion was particularly rapid following the suspension at midyear of interest rate ceilings on large negotiable certificates of deposit (CD's) in the 30- to 89-day maturity range. In total, the greater inflow of time and savings deposits considerably increased the availability of funds seeking investment in mortgages, State and local government securities, and short-term business and consumer loans.

Federal fiscal policy also turned more stimulative in 1970: (1) The 10 per cent surcharge on income taxes was terminated in two stages; (2) the first of the reductions contained in the Tax Reform Act of 1969 became effective; and (3) a sharp increase occurred in Federal expenditures—mainly through enlargement of grants-in-aid to local governments and transfer payments to individuals. Even though Federal purchases of goods and services declined slightly in dollar terms as a result of an appreciable reduction in the defense budget, the effect of fiscal policy was to increase consumer disposable income and to buttress State and local government expenditures.

Despite these measures, aggregate economic activity lagged throughout 1970 and output fell increasingly below the Nation's expanding output potential. At the year-end the unemployment rate was up to 6.2 per cent, as against 3.5 per cent a year earlier, and manufacturing facilities generally were being operated at well under preferred rates. In terms of real GNP, the shortfall in output of goods and services below full employment levels at the year-end exceeded 5 per cent. At current prices, this represented a shortfall of more than $50 billion at an annual rate.

In view of the gap that has developed in the economy's performance relative to potential, and of the accompanying unemployment and under-utilization of the Nation's human resources, the emphasis in public policy continues to be on the restimulation of economic activity. At the beginning of 1971, depreciation schedules on purchases of business equipment were liberalized for tax purposes in order to enhance the prospective return on, and thereby stimulate, such investment. The Federal budget proposed for fiscal year 1972 calls for an increase in total expenditures of $16.2 billion—about the same as is projected for the fiscal year 1971—and although balanced in terms of the revenues that would be produced at full employment, it will involve a substantial, realized deficit.

Monetary policy is also on an expansive course, as reflected not only in the substantial growth in money, bank credit, and financial flows, but also in marked declines in interest rates. In designing policies to help revitalize the economy, of course, care must be taken not only to avoid encouraging a rebound that is so swift as to regenerate inflationary pressures and expectations, jeopardizing the hard-won progress that has been achieved in this area, but also to avoid weakening further the U.S. competitiveness in world markets.

It seems likely that an increasing number of sectors in our economy will contribute to economic expansion over the months ahead. Residential construction has already achieved near-record levels, reflecting both large pent-up demands for housing and the marked improvement during 1970 in the availability of funds for mortgage lending. And a large and increasing volume of bond financing by State and local governments points to a growing trend of expenditures for public facilities.

The outlook for spending by businesses in the coming year is still somewhat uncertain. Capital outlays are being adjusted downward in many industries, following a long period of very heavy investment spending. However, investment programs in some other industries—notably the utilities—continue to indicate sharp growth in capital outlays. Hence, the total dollar volume of capital spending, even though it has leveled off, may well remain close to the peak rates reached in 1970. Many businesses also worked during 1970 to trim and balance their inventory positions. But the degree of inventory adjustment was quite small by the standards of many other periods of sluggish economic activity.

The key to the speed and extent of economic recovery in 1971 may well prove to be in the hand of the consumer. Total income available for spending rose strongly during 1970—reflecting tax cuts, higher social security and other Federal transfer payments, and further growth in aggregate wages and salaries. But spending was sluggish. It rose less in current dollars than in other recent years—and little at all after adjustment for higher prices. Consumers were in a cautious mood—responding to rising prices, increasing unemployment, extended strikes, reduced overtime pay, an uncertain and at times sharply lower stock market, political and military tensions abroad, and social disorders at home. As a result, they restrained their buying and instead strengthened their financial positions through accumulation of liquid financial assets and repayment of debt.

An improvement in consumer sentiment now would serve to spur consumer spending, just as the deterioration in confidence earlier tended to restrict it. And stronger consumer markets would communicate strength to the business sector, would generate jobs and additional income, and would enlarge the tax revenues of governmental units hard pressed by sharp increases in operating costs.

On balance, prospects seem good for a resumption of growth in aggregate economic activity in 1971. Indeed, the recovery could prove to be relatively vigorous if consumers become more confident of future prospects and increase their propensity to spend accordingly. The prospects for sustaining economic expansion should be enhanced to the extent that such expansion is accompanied by increased efficiency in our economic processes through tighter management. Continued moderation in inflation is also an important pre-condition to lasting prosperity, and its achievement will require a gradual subsidence in the cost pressures that lead to higher prices of products and services.

The next section of this report describes monetary policy during 1970 in relation to broad financial and nonfinancial developments in the economy. In order to help evaluate the positions of key areas in early 1971, ensuing sections discuss recent trends in particular sectors or markets in terms of the types of adjustments made during the year to, among other things, the abatement of aggregate demands and the easing of monetary policy. A digest of the principal Federal Reserve policy actions in 1970 appears on pages I-VII, following page 28. □

Monetary Policy and the Economy in 1970

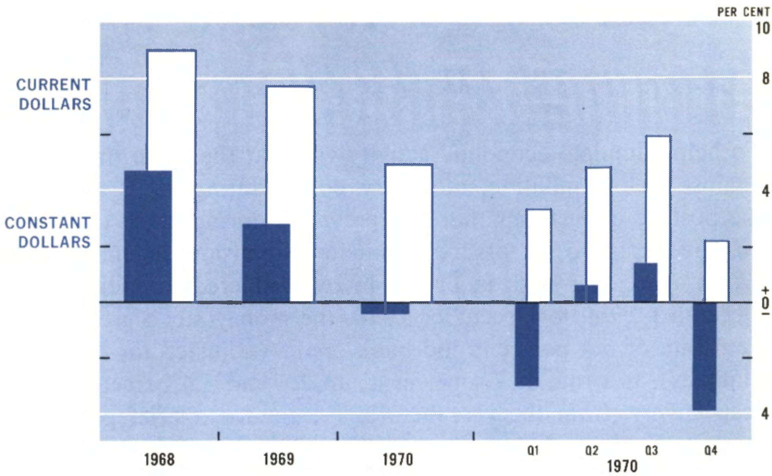
To help stimulate economic activity while at the same time guarding against fueling inflation, monetary policy during 1970 shifted from the posture of restraint that had prevailed during much of 1969 to a posture designed to assure adequate expansion in monetary and credit aggregates and an easing in over-all credit conditions. From December 1969 to December 1970, the money stock grew at an annual rate of 5.4 per cent and bank credit (adjusted for loan sales to affiliates) at a rate of 7.4 per cent, up 2.3 and 3.4 percentage points, respectively, from the year before. Except for a brief period in the second quarter, short-term interest rates declined sharply during 1970. On the other hand, long-term interest rates did not show significant net declines until the latter part of the year, because credit demands in bond markets remained strong and it took time for the inflationary expectations of investors and borrowers to begin abating. Once the decline in long-term rates got under way, however, it proceeded with a speed unprecedented in recent financial history.

DEMANDS FOR GOODS AND SERVICES

The weakening of demands in 1970 was reflected in production cutbacks in many industries. Output of goods and services (GNP) rose about 5 per cent from 1969 to 1970 in terms of current dollars. But all of the increase reflected a rise in the average level of prices, and in constant dollars GNP declined slightly. In goods-producing sectors, output dropped by 3 per cent from 1969 to 1970. The declines in industrial production were concentrated in defense products, off 19 per cent; in consumer durable goods, down 7 per cent; and in business equipment, off 4 per cent.

The weakness in the economy was exacerbated by the extended strike at a major automobile manufacturer, which lasted from September 14 to November 23. This strike contributed to the greater than 3 per cent decline (annual rate) in real economic activity in the fourth quarter. Apart from the effects of this strike, real GNP would probably have shown a further small increase in the last quarter of

1. CHANGE IN GNP



Dept. of Commerce data. Quarterly totals are at seasonally adjusted annual rates.

the year. Real GNP had shown small increases in the second and third quarters, following a decline of almost 3 per cent at an annual rate in the first quarter as businesses cut back substantially on their inventory investment.

Inventory policies of business were not a significant drag on the economy after the first quarter, however. Following the first-quarter decline in the rate of such investment, and a similar drop in the fourth quarter of 1969, inventory accumulation picked up somewhat, although the rate was still lower than at any other time since 1961. Altogether, the over-all adjustment of inventories was mild.

In the first half of 1970 consumer spending was bolstered by additions to disposable income resulting from a Federal pay raise, increases in social security benefits, and the first-stage reduction in the income tax surcharge. Nevertheless, the increase in such spending did not keep pace with the rise in income—as consumers resisted high and rising prices and as uncertain economic prospects also appeared to contribute to an increase in the propensity to save. The personal saving rate rose to 7.5 per cent by spring and changed little from this advanced rate in the second half of the year.

Growth in consumption outlays slowed further in the second half of the year, reflecting a much reduced increase in disposable personal income—despite elimination of the surtax at midyear—as employment showed only minor gains and the workweek was cut further in the third quarter. The smaller increase in spending resulted mainly from an actual drop in outlays on consumer durable goods. This drop became evident in the third quarter prior to the strike in the auto industry, and it was accentuated in the fourth quarter when expenditures for autos were cut sharply. Strike effects also contributed to a reduced rise in disposable personal income in the second half of the year, especially in the fourth quarter when such income grew at less than one-half of the third-quarter pace and at about one-fourth of the average rate for the first half.

In the business sector the principal development in 1970 was the ending of the long fixed investment boom, which had persisted with only minor interruptions since the early 1960's. Business spending on new fixed capital rose by only about 3 per cent from 1969 to 1970

TABLE 1: GROSS NATIONAL PRODUCT

Change from preceding period, in billions of dollars

Item	1968	1969	1970	1970			
				I	II	III	IV
Gross national product	71.1	66.4	45.1	7.8	11.6	14.4	4.4
Personal consumption expenditures	43.7	41.7	39.2	10.5	11.3	7.7	4.9
Durable goods	10.9	6.0	−.6	−1.7	2.8	−.7	−5.9
Nondurable goods	15.2	15.6	18.9	6.8	3.8	3.2	5.7
Services	17.6	20.0	21.0	5.4	4.7	5.2	5.1
Addendum: Saving rate (per cent)	6.8	6.0	7.3	6.7	7.5	7.6	7.4
Fixed investment	10.5	12.5	.9	−1.4	−.4	1.5	.8
Residential structures	5.2	1.7	−2.3	−1.3	−.7	.8	3.0
Nonresidential	5.4	10.6	3.3	.0	.2	.8	−2.3
Inventory change	−.6	.9	−5.0	−5.6	1.5	2.4	−1.9
Net exports of goods and services	−2.7	−.6	1.7	.9	.6	.1	−1.6
Exports	4.4	4.9	6.7	2.3	1.7	.0	−.8
Imports	7.1	5.5	5.0	1.4	1.1	−.1	.7
Govt. purchases of goods and services	20.1	12.0	8.3	3.3	−1.2	2.6	2.2
Federal	8.8	1.8	−1.6	.2	−2.6	−1.1	−.4
Defense	5.6	.8	−2.2	.5	−2.5	−1.0	−1.2
Other	3.1	1.1	.5	−.3	−.1	.0	.6
State and local	11.3	10.1	10.1	3.2	1.3	3.7	2.6

NOTE.—Based on data from Dept. of Commerce.

in current-dollar terms and actually declined after allowing for price increases.

The leveling off of expenditures for plant and equipment appeared to be in large part the product of developments cumulating over a long period. The sharp expansion in plant and equipment outlays in the second half of the 1960's ultimately gave rise to a drop in the rate of plant capacity utilization in manufacturing, which by the end of 1969 had declined to 83.7 per cent. In 1970, as defense production was reduced and consumer propensities to spend declined, capacity utilization rates dropped further—to 72 per cent by the end of the year. With wage costs and the costs of external funds rising sharply, business profits too came under pressure, and investment incentives were reduced. The weakening of investment incentives, however, was counterbalanced in part by the sharp drop in the cost of capital—as represented by long-term interest rates—in late 1970 and early 1971.

Other types of capital outlays were particularly responsive to emerging tightness or ease in credit markets. Residential construction expenditures, which had begun to decline in the second half of 1969, continued to drop in the first half of 1970 in lagged response to the reduced availability and higher cost of funds from private lenders. The decline from mid-1969 to mid-1970 was less sharp than that during the 1966-67 period of mortgage market tightness, however. The fact that it was smaller reflected in part the expansion of Federal support programs to provide more insulation of the housing market from the effects of monetary tightness and in part a response to non-monetary factors that sustained the demand for homes.

With the turn toward monetary ease in early 1970, availability of funds in the mortgage market began to improve. The ensuing decline in short-term market interest rates was accompanied by a sharp increase in the net inflow of funds to savings institutions as the public diverted savings from market instruments to interest-bearing deposits. Although mortgage interest rates showed little net decline until late in the year, when they began to drop significantly, the increased availability of funds led to a rise in housing starts from a seasonally adjusted annual rate of 1.25 million units in the first quarter to an average of 1.75 million units in the fourth quarter. And outlays for residential construction turned up in the second half of the year. The dollar rise in the fourth quarter was the largest in 3 years.

Purchases of State and local governments rose by only about the same amount from 1969 to 1970 as they had the year before, despite a 20 per cent increase in Federal grants-in-aid from 1969 to 1970. Normally, increases in such purchases have tended to accelerate from year to year as the demand for public facilities and services has expanded. But spending was held back in 1970 as a result of the financing difficulties that many governments encountered in late 1969 and early 1970. Debt issues were difficult to place in view of the tight position of commercial banks, which are principal buyers of such issues; and in some cases governments were unable to issue bonds because of restrictive interest rate ceilings imposed by State regulations or public referenda. As 1970 progressed, however, the easing in the availability of funds at banks helped to facilitate marketing of a larger volume of issues. Since there is a substantial lag between financing and actual spending, State and local government capital outlays by year-end had not yet risen appreciably.

FEDERAL BUDGET

Demands by the Federal Government for goods and services moderated in 1970. In fact, the total of such purchases, as measured in the national income accounts, declined for the first time in 10 years. The $2 billion year-over-year decline in defense spending reflected substantial reductions in real terms, including a reduction of 318,000 in the size of the Armed Forces and sizable cutbacks in orders and deliveries of defense products. The budgetary reductions in defense spending occurred despite a sizable increase in U.S. Government compensation for military and civilian employees. Increases in purchases of nondefense goods and services were minor. On the other hand, Federal expenditures other than purchases rose by about $16.5 billion from 1969 to 1970, a record increase. In addition to the larger grants-in-aid to State and local governments already noted, social security payments rose—a 15 per cent increase in benefits was enacted in April retroactive to the first of the year—and medicare programs and unemployment compensation also entailed larger disbursements.

Total Federal receipts, as measured in the national income accounts, dropped by about $5 billion in 1970, reflecting principally the effects of the elimination of the 10 per cent tax surcharge. In addition, however, growth in taxable income of businesses and consumers was considerably below normal.

With receipts dropping and total expenditures continuing to rise, the Federal sector of the national income accounts showed a deficit of $11 billion in 1970, following a $9 billion surplus in 1969. The unified budget also shifted into sizable deficit during the year, and the Federal Government once again became a large net borrower in credit markets.

The extent of the swing from budgetary surplus in 1969 to deficit in 1970 was, as noted above, strongly influenced by the sluggish pace of economic activity. To that extent it was not reflective of a more active fiscal policy. But in addition, certain discretionary changes—such as the reduction in tax rates—were undertaken that moved fiscal policy in a somewhat more expansive direction.

TABLE 2: FEDERAL GOVERNMENT RECEIPTS AND EXPENDITURES

In billions of dollars

Item	Calendar year			1970			
	1968	1969	1970	I	II	III	IV
	Federal Sector NIA basis (Annual totals, or quarterly totals at seasonally adjusted annual rates)						
Receipts	175.4	200.6	p 195.2	195.9	196.7	194.9	e 193.3
Expenditures	181.6	191.3	p 206.3	197.7	210.9	206.7	p 209.9
Purchases of goods and services	99.5	101.3	p 99.7	102.3	99.7	98.6	p 98.2
Other	82.1	90.0	p 106.6	95.4	111.2	108.1	p 111.7
Surplus or deficit	−6.2	9.3	p −11.1	−1.7	−14.2	−11.8	e −16.6
	Unified budget (Annual totals, or quarterly totals not seasonally adjusted)						
Receipts	169.4	195.7	190.5	44.4	58.6	46.5	41.1
Outlays	185.5	190.3	201.9	47.8	49.8	54.3	49.9
Budget surplus, or deficit	−16.1	5.4	−11.4	−3.5	8.7	−7.8	−8.9
Net cash borrowing	15.3	−2.6	11.8	2.0	−6.4	7.4	8.9

e Estimate.
p Preliminary.
NOTE.—The Federal sector in the national income accounts measures Federal receipts and expenditures as they directly affect private incomes in the national accounts. Thus it excludes all Federal lending, which affects private debt but not incomes. Also the timing in some transactions is on an accrual basis; in others, on a delivery basis. Generally speaking, the unified budget includes lending by federally owned agencies (but not that of federally sponsored corporations), and it records Federal transactions on a cash basis.

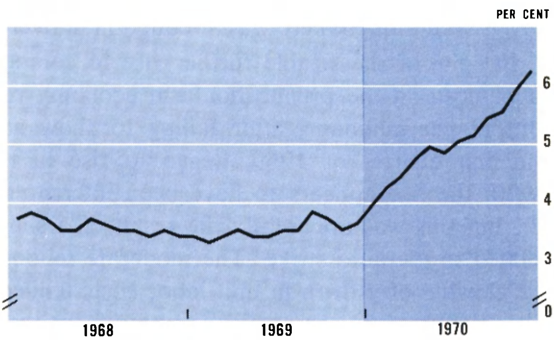
A measure of the extent of the change in fiscal policy is provided by the "full employment" budget. There are a number of different ways of measuring expenditures and receipts under the full employment concept, but all show a decline in the full employment surplus from 1969 to 1970. According to the measure calculated by the Council of Economic Advisers, the drop in the full employment surplus was about $5 billion, but there was still a moderate surplus for the calendar year 1970.

RESOURCE UTILIZATION AND PRICES

The weakening of aggregate demands for goods and services in 1970 was reflected, in turn, in reduced demands for labor. While reflecting in part the effects of the auto strike, total civilian employment showed practically no net change from the fourth quarter of 1969 to the fourth quarter of 1970. Although growth was considerably less than in 1969, the total labor force continued to expand substantially. Growth in the civilian labor force was further raised by the reduction in the size of the Armed Forces. The rate of unemployment rose from an average of 3.6 per cent in the fourth quarter of 1969 to 5.9 per cent in the last quarter of 1970. For the year as a whole, it averaged 4.9 per cent.

In manufacturing industries, employment by the end of 1970 was down sharply—by about 1.3 million workers—from a year earlier. During the year employment demands diminished over a broad spectrum of manufacturing, including both defense activities and civilian industries. Layoffs affected production workers for the most part.

2. UNEMPLOYMENT RATE



Bureau of Labor Statistics data.

However, in view of the pressures on profit margins, businesses were very sensitive to the need for reducing costs, and as a result employment of nonproduction workers too was cut substantially, especially in the defense-products industry.

TABLE 3: LABOR MARKET INDICATORS

Item	Change (in thousands of persons) during year ending Q4:		
	1968	1969	1970
Total labor force	1,031	2,339	1,331
Armed Forces	73	−53	−444
Civilian labor force	958	2,392	1,774
Employed	1,312	2,167	−1
Unemployed	−353	224	1,775
Nonfarm employment (based on payroll data):			
Manufacturing	439	184	−1,455
Production workers	315	55	−1,265
Other	124	129	−190
Private nonmanufacturing	1,440	1,502	364
Government	425	341	453
Federal	−23	5	−66
State and local	448	336	518

Despite a weakening in demand for labor, upward wage pressures continued strong, reflecting both the large number of union wage contracts that came up for renewal and the attempts of both union and nonunion workers to make up for previous—or to anticipate future—cost-of-living increases. Compensation per manhour in the private nonfarm sector of the economy increased by about 7 per cent on the average in 1970, very little different from the increase in 1969, even though there was a reduction in overtime work.

In spite of the sizable further rise in compensation in 1970, unit labor costs in the private nonfarm economy rose less than in 1969. Output per manhour, after failing to show any improvement since the first quarter of 1969, began to rise in the second quarter of 1970; the rise appears to have been interrupted in the fourth quarter, but this was apparently the result of a sharp drop in production related to the auto strike. The moderate rebound in productivity and the slowing of growth in unit labor costs tended to ease, to some degree, the pressures on profits resulting from the slackness in demands for industrial output and for services; still, the general pressures on profit margins caused businesses to raise prices further.

Progress toward containing the rate of inflation was slow. The rate of increase in wholesale prices of industrial commodities diminished somewhat, from an average annual rate of 3.8 per cent in the first half of the year to 3.4 per cent in the second half. However, prices of finished goods rose sharply in the fourth quarter in reflection of upward adjustments in passenger car prices. But nonfood crude materials, excluding fuels, declined in price during the last three quarters of the year. The consumer price index rose somewhat more moderately in the second half of the year than it had in the first half, largely as a result of an increase in food supplies, mainly meat.

Although the increase in average consumer prices moderated somewhat, there were a number of areas—such as construction costs—in which price increases, reflecting the upward momentum gathered over the past several years, continued to be very strong. Nevertheless, as measured by the private GNP implicit deflator, the rate of price increase over-all seems to have leveled off during the year, if rough allowance is made for the technical effects of the auto strike on the composition of fourth-quarter output and hence on the computation of the deflator.

TABLE 4: PRICE CHANGES

In per cent

Category	Year				1970 annual rate[1]			
	1967	1968	1969	1970	Dec.–Mar.	Mar.–June	June–Sept.	Sept.–Dec.
Wholesale prices, total	.9	2.8	4.7	2.3	4.0	1.1	3.9	.4
Industrial commodities	1.9	2.6	3.9	3.6	3.1	4.5	2.9	3.8
Crude materials [2]	1.0	−1.3	7.3	−1.2	9.5	−2.6	−7.3	−3.8
Finished goods	2.4	2.4	3.4	4.3	2.8	2.8	2.8	8.8
Farm products, processed foods, and feeds	−1.8	3.5	7.3	−1.2	6.8	−9.9	8.9	−9.2
Consumer prices, total	3.0	4.7	6.1	5.5	6.3	5.8	4.2	5.7
Food	1.2	4.3	7.2	2.2	5.4	1.3	1.4	.9
Other commodities (less food)	3.2	3.7	4.4	4.8	2.9	6.4	3.7	6.4
Services	3.9	6.1	7.4	8.2	11.2	7.3	7.2	7.0
GNP, private implicit deflator	3.0	3.8	4.7	5.0	5.3	4.1	4.7	5.8

[1] Compounded.
[2] Excludes foods, feeds, and fuels.
NOTE.—All data are seasonally adjusted except for crude materials and finished goods in wholesale prices and services in consumer prices. Annual changes calculated December to December, except for deflator for which quarterly data are used throughout.

BALANCE OF PAYMENTS

There were divergent trends in the current and capital accounts of the U.S. balance of payments during 1970. In the first half of the year the trade balance strengthened considerably, under the influence of lessened demand pressures here and a high level of activity in most industrial countries. However, the trade surplus declined after midyear as imports rose further despite the growing slack in the U.S. economy, while exports fell off somewhat in response to an easing of the rate of expansion abroad. On the other hand, net outflows of long-term capital were very large in the first half, as U.S. direct investors placed large amounts abroad while foreign investors were net sellers of U.S. corporate stocks. Foreign purchases of equity securities were resumed on a substantial scale in June, and the outflow of funds from U.S. corporations for direct investment abroad appeared to be much less in the second half of the year.

In total, the liquidity measure of the U.S. balance of payments showed a small improvement in 1970—registering a deficit of about $5 billion, or $1 billion less than in 1969 (balances adjusted to exclude special transactions and, in 1970, the allocation of SDR's). Gains in the liquidity balance reflected primarily an improvement in

TABLE 5: U.S. INTERNATIONAL TRANSACTIONS

In billions of dollars, seasonally adjusted

Item	1969	1970[e]	1970			
			I	II	III	IV[e]
Goods and services, net	1.9	3.6	.8	1.1	1.0	.7
Exports	36.5	42.0	10.2	10.7	10.7	10.4
Imports	−35.8	−39.8	−9.7	−9.9	−10.0	−10.3
Trade balance	.6	2.2	.5	.8	.7	.1
Services, net	1.3	1.4	.3	.3	.3	.5
All other transactions corresponding to liquidity basis[1]	−7.9	−8.5	−2.1	−3.2	−1.7	−1.5
Liquidity balance adjusted[1,2]	−6.0	−4.9	−1.3	−2.1	−.7	−.8
Liquid liabilities to:						
Foreign commercial banks	9.2	−6.5	−1.9	−.1	−1.4	−3.1
Other private foreigners[3]	−.5	.3	....	.1	−.1	.3
Official settlements balance adjusted[1,2]	2.8	−11.0	−3.2	−2.1	−2.1	−3.6

[e] Estimated.
[1] Excludes special transactions.
[2] Excludes SDR allocation.
[3] Includes international organizations.
NOTE.—Details may not add to totals because of rounding.
SOURCE.—*Survey of Current Business* and Federal Reserve estimates.

the trade balance from a slim $0.6 billion surplus in 1969 to a surplus of about $2.2 billion in 1970, plus somewhat larger net receipts of investment income.

A major feature of the U.S. accounts in 1970 was a net reduction of more than $6 billion in liabilities of U.S. banks to foreign commercial banks through their branches. These borrowings had been built up mainly in 1969 when monetary restraint and the low level of Regulation Q ceiling rates relative to domestic market rates had limited the growth of bank liabilities to domestic holders. As funds borrowed from abroad were returned to the Euro-dollar market, the dollar holdings of foreign monetary authorities grew rapidly. Consequently, the balance on the official reserve transactions basis (excluding special transactions and the allocation of SDR's) registered a deficit of $11 billion, reversing the $2.8 billion surplus of 1969.

INSTRUMENTS OF MONETARY POLICY

During 1970, as usual, the Federal Reserve relied mainly on open market operations in encouraging growth in the monetary aggregates and easier credit market conditions. But it also used other monetary policy instruments as the stance of policy was adapted during the year to emerging sectoral, liquidity, and balance of payments problems.

Early in the year the Board of Governors announced an across-the-board increase in the maximum interest rates payable by member banks on time and savings deposits. The realignment was part of a coordinated move on the part of the Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board that involved general increases in ceiling rates on deposits at both banks and nonbank thrift institutions. In addition to an upward scaling of ceilings by maturity on both large time CD's and—for the first time—consumer-type time certificates, maximum rates payable on savings deposits at commercial banks were raised for the first time in several years. This latter change reflected efforts to introduce greater equity into rates payable for smaller savings balances.

More broadly, these actions were designed to bring rates payable by banks and other savings institutions for deposits more into line with rates prevailing at the time on competing market securities. It was expected that the realignment of deposit rates with market rates would help to generate the deposit funds needed to finance a moderate pick-up in the growth of credit flows through financial institutions.

In May and June, Federal Reserve authorities took several actions to assure that the System would fulfill effectively the oldest and most traditional central banking function—that of serving as lender of last resort and of alleviating liquidity squeezes. In that period U.S. money and capital markets were experiencing unusual strains. Among the causes of these tensions were heavy corporate demands for long-term credit, expectations of a large volume of borrowing by the U.S. Treasury in the latter half of the year, concern that some prominent firms were financially over-extended and might not be able to refinance their short-term obligations, a sharp drop in stock market prices, and unsettlement arising from the unexpected U.S. involvement in Cambodia. While anxieties in financial circles that a general liquidity squeeze was emerging proved to be clearly exaggerated, it is true nonetheless that their net effect was to cause a sharp increase in over-all demand for liquidity. In view of these market uncertainties and liquidity strains, open market policy gave first priority in this period to moderating pressures on financial markets. And in May the Board of Governors reduced margin requirements on equities from 80 to 65 per cent, and on convertible bonds from 60 to 50 per cent.

In recognition that pressures might pyramid in the commercial paper market after a major railroad filed for reorganization in mid-June, the authorities supplemented their efforts to ameliorate market strains through open market policy with other policy measures. It was made clear that the Federal Reserve discount window would be available to assist banks in meeting the needs of businesses unable to roll over their maturing commercial paper. Also the Board of Governors moved promptly to suspend maximum rate ceilings on large-denomination CD's with maturities of 30 to 89 days.

This action enabled banks to obtain funds that investors had become reluctant to place in other markets and to rechannel these funds to borrowers previously dependent on the issuance of commercial paper. Aided by these Board actions, banks responded effectively to the midyear shifts in demands for funds, and the widespread concern that a lessening of investor participation in the commercial paper market might trigger a series of business bankruptcies subsided.

In mid-August, after conditions in the commercial paper market had calmed, the Board announced the application of a 5 per cent reserve requirement against funds obtained by member banks through the issuance of commercial paper by their affiliates. This action was designed to put bank-related commercial paper, which is typically issued in denominations of $100,000 or more, on a substantially equal footing—in terms of reserve requirements—with large negotiable time CD's. A somewhat similar proposal, with a higher reserve requirement, had been published for comment in January, but given the interim course of economic and financial developments, circumstances were not appropriate for its adoption.

The extension of reserve requirements to bank-related commercial paper was accompanied by a reduction from 6 to 5 per cent in the reserves that member banks must hold against time deposits in excess of $5 million. These two actions, in combination, resulted in a net reduction in required reserves of about $400 million for the banking system as a whole. Most of the reduction in reserves affected banks that might be expected to be relatively active lenders in markets for mortgages and State and local government securities.

An additional reserve requirement action, announced at the end of November, was designed to have an effect on the balance of payments. In the closing months of the year further declines in U.S. short-term interest rates were sharply increasing the relative costs for major U.S. banks of borrowing Euro-dollars in lieu of domestic short-term funds. This widening of rate spreads threatened to cause large U.S. bank repayments of Euro-dollar borrowings, and a consequent deepening of the very large official settlements deficit in the U.S. balance of payments.

Therefore, to temper Euro-dollar reflows, the Board of Governors amended Regulations D and M to increase—from 10 to 20 per cent—the reserve ratio required on Euro-dollar borrowings exceeding the average level that is reserve-free. This reserve-free base declines as the average level of Euro-dollar borrowings is reduced below a line established for the individual bank. The doubling of the reserve ratio was expected to moderate further outflows of bank-held Euro-dollars by enhancing the prospective value of existing reserve-free bases.

After April 1969 market interest rates had moved well above the discount rate, but by October 1970 declines in such rates had again brought the discount rate about in line with the market. When short-term market rates then dropped below the discount rate during November, the Federal Reserve lowered the discount rate to bring it into closer alignment with market rates. Effective November 11 and December 1, the rate was reduced from 6 to 5½ per cent. These were the first changes in the discount rate since April 1969, and the first cuts since a ¼ percentage point reduction in mid-August 1968, and before that a ½ percentage point reduction in early April 1967. Two further reductions of ¼ percentage point in the discount rate were made in early 1971, as short-term market rates dropped further, and at the end of January 1971 the discount rate was 5 per cent.

MONETARY AGGREGATES

In the latter half of 1969 growth of the narrowly defined money stock had slowed to a virtual halt, and bank credit—as measured by the adjusted bank credit proxy—had contracted slightly. In moving from a restrictive to a more expansionary monetary policy in early 1970, the Federal Open Market Committee sought to achieve moderate growth in money and bank credit. To implement its policy of encouraging more rapid growth in such aggregates, the Committee placed somewhat greater emphasis on the monetary aggregates in the operating instructions given to the System Account Manager for guidance in the day-to-day conduct of open market operations. The Committee did not decide to pursue fixed target rates of growth of the monetary aggregates in any exclusive sense, however, and it continued to adjust its stance as required to meet other policy objectives—for example, the need already noted to cope temporarily with liquidity strains and undue pressures in security markets.

Reflecting the diversity of operating targets, the large variations often found in month-to-month deposit data, and what seemed to be temporary but sharp shifts in the public's willingness to hold cash, the growth rate of the narrowly defined money stock in 1970 sometimes fluctuated fairly widely. Over the year as a whole, however, the money stock expanded by 5.4 per cent. During each of the first three quarters of the year the annual rate of growth averaged close to 6 per cent. Although the growth rate then dropped to about 2 per cent on the average in October and November, when demands for money

TABLE 6: CHANGES IN SELECTED MONETARY AGGREGATES

Item	1968	1969	1970	1969 1st H	1969 2nd H	1970 1st H	1970 2nd H
	In per cent; quarterly figures, at seasonally adjusted annual rates						
Total reserves	7.8	−1.6	6.4	.7	−3.9	−.2	13.0
Concepts of money:							
M_1 (Currency plus demand deposits[1])	7.8	3.1	5.4	5.1	1.2	5.9	4.8
M_2 (M_1 plus time deposits at commercial banks other than large time CD's)	9.4	2.4	8.2	5.1	−.4	5.9	10.2
M_3 (M_2 plus deposits at nonbank thrift institutions)	8.4	2.8	7.9	5.1	.4	5.3	10.2
Bank credit:							
Bank credit proxy adjusted[2]	9.8	.2	8.3	1.6	−1.2	3.5	12.9
Loans and investments of commercial banks[3]	11.0	4.0	7.4	5.1	2.9	4.5	10.1
	In billions of dollars						
Memo items on short-term market paper:							
Large time CD's at banks	2.9	−12.8	14.8	−8.2	−4.6	2.0	12.8
Euro-dollar borrowings	2.6	6.8	−6.0	4.8	2.0	−1.9	−4.1
Bank-related commercial paper and other nondeposit sources	....	[e] 5.9	−2.4	[e] 2.8	3.1	2.6	−5.0

[e] Estimated.
[1] Currency held outside the Treasury, F. R. Banks, and the vaults of all commercial banks, plus demand deposits other than interbank and U.S. Government.
[2] Total member bank deposits subject to reserve requirements, plus Euro-dollar borrowings, bank-related commercial paper, and certain other nondeposit items. This series for deposits is referred to as "the adjusted bank credit proxy."
[3] Based on month-end figures. Includes loans sold outright to affiliates and branches.

were temporarily affected by the dampening effect of the auto strike on economic activity, in December it again moved up to 6.2 per cent.

Broader measures of the money stock—which encompass various types of time and savings deposits as well as private demand deposits and currency, such as the M_2 and M_3 concepts listed in the accompanying table—showed substantially more rapid growth in 1970 than M_1 (narrowly defined money stock). Moreover, the growth in these aggregates accelerated in the second half of 1970. As already noted, the stage had been set for expansion in these other measures when ceiling rates of interest were increased in January for time and savings deposits at all types of thrift institutions.

As market interest rates moved down toward, and below, these higher ceilings, savings inflows accelerated at both bank and nonbank thrift institutions. Although this pick-up began as early as February, the inflow gained momentum during the second quarter and was most pronounced after midyear. The late June suspension of ceiling rates on large short-maturity bank CD's triggered an abrupt increase in such instruments during the third quarter. And for the year as a whole the total growth in CD's more than offset the sharp contraction that had occurred in 1969.

The expansion was not limited to CD's, however. Consumer-type time and savings accounts at banks grew nearly as much as CD's in the third quarter, and for the year as a whole their expansion was substantially larger than that of CD's. A somewhat similar growth pattern was evident at savings and loan associations and, with some lag, at savings banks as well. Apparently consumers were encouraged to add to liquidity in these forms by several factors: the dramatic improvement of yields on such accounts relative to market rates; a desire to maintain their financial asset holdings in risk-free form; and a more conservative attitude on their part toward spending, as overtime hours of work dropped and unemployment widened.

To a considerable extent the rapid growth of large CD's indicated that banks were using this less costly and more convenient means of obtaining funds instead of borrowing through the Euro-dollar market or issuing bank-related commercial paper. After the Board announced the extension of reserve requirements to bank-related commercial paper, the volume of such paper outstanding declined by $5.2 billion through December. And over the full year, as domestic markets for short-term funds became relatively more attractive, major banks reduced their Euro-dollar borrowing by more than $6 billion. Nevertheless, when bank funds from these sources are added to deposits, as in the adjusted bank credit proxy, the growth in this comprehensive measure was still sizable—more than 8 per cent for the year, as compared with less than one-half of 1 per cent for 1969. Moreover, growth in bank credit—like that in the broader measures of money and liquidity—accelerated in the second half of 1970.

The total reserves that support aggregate member bank deposits grew by 6.4 per cent in 1970; expansion was especially rapid in the second half of the year. Nonborrowed reserves provided to banks through open market operations rose more rapidly than the total, as member banks reduced their borrowings at Federal Reserve Bank discount windows from around $1 billion early in 1970 to a range of $200 million to $300 million at the year-end. Over the same period net borrowed reserves (excess reserves less borrowings) dropped from around $800 million to virtually zero, with excess reserves rising modestly over the year as short-term interest rates—representing the cost of holding excess reserves—declined sharply.

Part of the rapid expansion in bank credit in 1970 represented a channeling of funds through the banking system, whereas in 1969 funds had been going directly into market securities. Perhaps the most dramatic illustration of this rechanneling process occurred during the squeeze on the commercial paper market in late June and July when outstanding nonbank commercial paper declined by more than $2 billion in the course of a few weeks, while bank CD's and loans to businesses and to finance companies showed a marked expansion.

Although movement of funds back into banks and into nonbank savings institutions was an important aspect of credit flows in 1970, there was also an increase in the over-all availability of credit and in the actual amount of funds raised, as both institutions and direct market participants became more willing lenders. Total funds raised by nonfinancial sectors rose by about $14 billion (annual rate)—or 16 per cent—from the second half of 1969 to the second half of 1970,

Table 7: Funds Raised by Nonfinancial Sectors

In billions of dollars; half-year figures, at seasonally adjusted annual rates

Sector	1968	1969	1970	1969		1970	
				1st H	2nd H	1st H	2nd H
Total	97.4	88.2	96.1	88.8	87.8	89.1	101.5
U.S. Government	13.4	−3.6	11.9	−9.3	2.0	8.7	13.6
Total, other nonfinan. sectors[1]	84.1	91.9	84.2	98.1	85.8	80.4	87.9
State and local govt. issues	10.2	8.9	12.6	10.0	6.9	10.1	15.1
Nonfinancial corporate business:							
Bonds and stocks	12.1	16.4	27.9	14.8	17.9	24.6	31.2
Mortgages	5.8	4.3	5.0	4.6	4.0	4.5	5.5
Commercial paper	1.6	2.7	2.8	3.8	1.5	3.1	2.4
Bank loans	9.6	10.9	....	13.4	8.3	3.9	−3.9
Consumers:							
Consumer instalment debt	9.0	8.3	3.0	8.9	7.9	4.3	1.7
Mortgages	16.0	17.4	13.0	18.0	16.7	13.5	14.6

[1] Includes borrowing other than the types shown below.
Note.—Flow of funds data.

over a period when interest rates were showing substantial declines. The increase in funds raised reflected larger borrowings by the U.S. Government, while funds raised by other sectors were little changed between the two periods.

INTEREST RATES AND CREDIT FLOWS

Declines in U.S. short-term market rates of interest in 1970 were the most dramatic in absolute terms for any year in the postwar period. The reductions ranged from about 3 to 4 percentage points, or from about one-third to nearly one-half of their levels prevailing in December 1969. Declines in long-term market rates, while also large, ranged only from about one-tenth to nearly one-fourth of their December 1969 levels, although this amounted to 1 to 1½ percentage points in yield. As a result of their much wider swing, short-term rates generally moved from a position of historically wide spreads above, to one of wide spreads below, long-term rates.

TABLE 8: CHANGES IN SELECTED INTEREST RATES, 1970

In basis points

Series	Total, Dec.'69 to Dec.'70	Dec.'69 to Mar.'70	Mar.'70 to spring high	Oct.'70 to Dec.'70
Short-term:				
Federal funds	−407	−121	+34	−130
Treasury bills	−295	−119	+20	−104
Commercial paper	−311	[1] −78	[1] +23	−112
Euro-dollars	−384	−221	+51	−69
Long-term:				
Corporate Aaa	−95	−15	+51	−83
U.S. Govt	−126	−58	+84	−94
State and local govt	−136	−79	+97	−93

[1] Periods used are December to April and April to the spring high, since changes in this series lagged behind the changes in other short-term rates.

NOTE.—Changes are calculated from monthly averages. Treasury bills, 3-month market yield; commercial paper, 4-6 months; Euro-dollars, 3-month; corporate Aaa, new issues, FRB series; U.S. Govt., 10-year constant maturity; State and local govt., from the Bond Buyer.

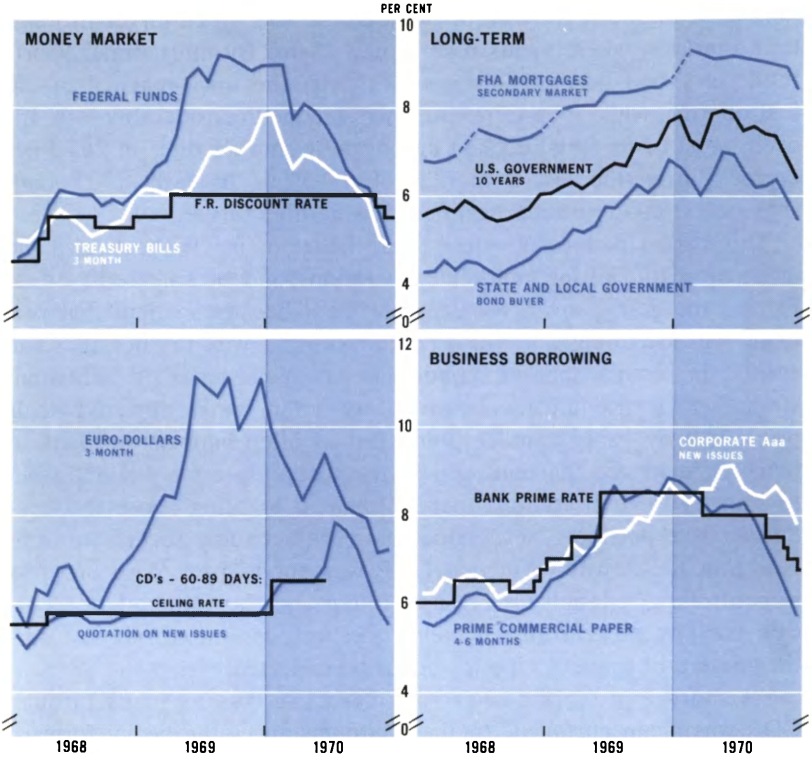
The pattern of change within the year was also somewhat different for short- as compared with long-term rates, although rate declines in both maturity sectors during the first quarter were generally typical of what might be expected at a cyclical downturn in rates. In the second quarter, even though interest rates rose in both short- and long-term markets, the size of the increase was much larger in long-term markets, where yields rose to new highs. By midsummer short-term rates had generally dropped through the lows reached in the first quarter, while long-term rates had declined considerably less. Indeed, most of the total decline in long-term market rates in 1970 occurred during the last 2 months of the year. In early 1971 both short- and long-term rates declined considerably further.

This varied pattern of interest rate behavior in 1970 reflected the interaction of shifting market expectations and actual credit flows. During the first quarter, for example, as it became evident that real GNP was declining and the Federal Reserve was promoting some easing in credit market conditions, financial market sentiment strengthened dramatically, particularly after banks lowered their prime rate by ½ percentage point. But as often happens in financial markets, evidence that emerged in the second quarter did not seem to support the expectations that had helped to bring about the first-quarter rate declines. News concerning the economy seemed to indicate that the downturn in real GNP was about over. With progress in controlling inflation also disappointing and the Cambodian incursion creating general unsettlement, question was raised whether further easing of monetary policy could be expected.

As short-term market rates rose, banks' access to funds through CD's was again curtailed. In these circumstances the heavy forward calendar of corporate and municipal borrowing, the large prospective volume of U.S. deficit financing in the second half of the year, and the growing concern that some major firms were financially over-extended, all contributed to an abrupt weakening of market psychology. In the face of this sharply changed outlook, borrowers actually coming to market had to pay substantially higher rates.

Accompanying the strains in security markets in the second quarter, depositary institutions generally experienced a noticeable improvement of deposit flows as consumers placed a greater premium on risk-free financial assets. These flows permitted the commercial banking system to add significantly to liquid asset positions. After midyear, with the suspension of rate ceilings on short-maturity time CD's and the relaxation of tensions in the commercial paper market,

3. SHORT- AND LONG-TERM INTEREST RATES



market interest rates turned down again, and deposit flows to banks became much larger, as noted earlier. In addition to financing the large volume of business and finance company borrowing transferred from the commercial paper market to the banks, these enlarged deposit flows permitted a substantial further expansion in bank holdings of U.S. Government and of State and local government securities. In this way the heavy increases in borrowing by these two levels of government during the second half of 1970 were financed at generally declining rates.

During the summer months—perhaps because of the large amount of refinancing by borrowers who were transferring out of the commercial paper market—banks generally presumed that underlying demands for business loans were still strong. Hence, there was no significant relaxation of loan terms, even though bank liquidity increased greatly. But by mid-September, when corporate tax payments became due, it became apparent that business borrowing at banks had dropped off sharply, and shortly after that, banks cut the prime rate by another ½ percentage point to 7½ per cent. Nevertheless, there was still considerable uncertainty about the underlying strength of business loan demand, for the trend in such lending was being obscured by the effects of the auto strike and also by the large repayments of loans arising from the heavy volume of corporate financing then under way in capital markets. In the expectation that these two temporary drags on loan growth would soon end, bankers tended to hold off on further reductions in the prime rate.

In November and December, however, with no sign of any significant pick-up in demand for loans and with plenty of liquidity, banks reduced the prime rate further, in a series of ¼ percentage point changes, from 7½ to 6¾ per cent by the year-end. The Federal Reserve discount rate was also reduced in this period. And there were further general declines in both short- and long-term market rates, even though the volume of new corporate and municipal bond offerings remained very large. Moreover, earlier accumulations of savings flows, liquidity, and commitments at nonbank thrift institutions were finally reflected in widespread reductions in interest rates on mortgages—including a cut, from 8½ per cent to 8 per cent, in the ceiling rate on federally underwritten mortgages.

These declines continued into 1971. The bank prime rate was cut successively from 6¾ to 6 per cent; the Federal Reserve discount rate was reduced further in two steps from 5½ to 5 per cent; and the FHA-VA mortgage rate ceiling was reduced in mid-January from 8 to 7½ per cent. □

Wages, Productivity, and Prices

In view of the sluggishness of the economy, the main thrust of monetary policy during 1970 was directed toward achieving financial conditions that would stimulate demands for goods and services. At the same time, however, persisting inflationary pressures, generated mainly from the cost side, remained a very serious problem for the economy and a threat to the efficiency of its future performance. Thus, the interrelationships among wages, productivity, and prices that appear to be developing are critical factors in appraising the progress being made toward setting the stage for sustainable, non-inflationary economic growth.

In the latter half of the 1960's, excess demand persisted for an exceptionally long period, with the unemployment rate dropping and remaining below 4 per cent. Strong demands for goods and services exerted upward pressures on prices, and the associated competition for labor resulted in sizable wage increases, which on the average exceeded gains in productivity. Price and wage increases became mutually reinforcing in an upward spiral.

During the latter half of 1969 and early 1970, the demand-pull component of the inflationary spiral was broken. Total real output of goods and services rose only moderately in 1969, and indeed had declined in the fourth quarter. In 1970 demands for goods and services continued weak while productive capacity continued to expand; there was a marked further reduction in the rate of capacity use in manufacturing and a considerable easing in labor markets. Under these circumstances, the persistent increase in 1970 in the principal indexes of prices resulted, for the most part, from continued pressures associated with costs. The dominating role of costs in the further price increase is indicated by the sharp decline in the ratio of prices to unit labor costs in manufacturing. This ratio, which had reached a high of 105 (with 1957-59 as 100) in the strong demand-pull inflation of 1965-66, had dropped to 97 by the end of 1969, and then declined further to 95 by the end of 1970. Concurrently with the decline in this ratio, after-tax profits per dollar of sales in

Principal Federal Reserve Policy Actions, 1970: Digest

Principal Federal Reserve Policy Actions, 1970: Digest

Period, or announcement date	*Action*	*Purpose*
January	Directed that System open market operations be conducted with a view to maintaining firm conditions in the money market, while taking account of the desire of the Federal Open Market Committee to see a modest growth in money and bank credit, with a provision for modification of operations depending on the course of money and bank credit developments.	To foster financial conditions conducive to the orderly reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.
January 20	Increased maximum interest rates payable by member banks on time and savings deposits, effective January 21. This action, in combination with a minor further amendment on February 26 (retroactive to January 21) bringing rates on multiple-maturity deposits in line with those on single maturities, set the following maximum rates: (1) Passbook savings, raised from 4 to 4.5 per cent. (2) Other types of consumer-type deposits—those of less than $100,000—raised as follows:	To readjust the structure of maximum interest rates payable by member banks for deposits to bring it somewhat more in line with going yields on market securities and to set the stage for renewed expansion of bank credit; to bring about greater equity in the rates payable on smaller savings balances, and to encourage longer-term savings within the framework of continued over-all credit restraint.

Maturity	Rate (%) New	Rate (%) Previous
Multiple-maturity:		
30-89 days	4.50	4.00
90 days to 1 year	5.00	5.00
Single-maturity:		
30 days-1 year	5.00	5.00
Single- and multiple-maturity:		
1 to 2 years	5.50	5.00
2 years or more	5.75	5.00

(3) Time deposits of $100,000 or more, raised as follows:

Maturity	Rate (%) New	Rate (%) Previous
30-59 days	6.25	5.50
60-89 days	6.50	5.75
90-179 days	6.75	6.00
180 days to 1 year	7.00	6.25
1 year or more	7.50	6.25

February

Directed that System open market operations be conducted with a view to moving gradually toward somewhat less firm conditions in the money market, taking account of the Committee's desire to see moderate growth in money and bank credit over the months ahead, with a provision for modification of operations depending on the course of money and bank credit developments.

To foster financial conditions conducive to the orderly reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

Principal Federal Reserve Policy Actions, 1970: Digest—Continued

Period, or announcement date	*Action*	*Purpose*
March through late May	Directed that System open market operations be conducted with a view to maintaining money market conditions consistent with the objective of moderate growth in money and bank credit over the months ahead, with a provision in effect during much of May for modification of operations as needed to moderate excessive pressures on financial markets, should they develop.	To foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.
May 6	Reduced the margin requirements on loans by banks, brokers and dealers, and other lenders for the purpose of purchasing or carrying registered equity securities from 80 to 65 per cent.	To be less restrictive in view of the sharp reduction in the use of credit for stock purchases.
	Reduced the margin requirements on such loans by these lenders against securities convertible into registered equity securities from 60 to 50 per cent.	
Late May through late July	Directed that System open market operations be conducted with a view to moderating pressures on financial markets while, to the extent compatible therewith, maintaining bank reserves and money market conditions consistent with the longer-run ob-	To foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of

	jective of moderate growth in money and bank credit, with allowance after late June for a possible shift of credit flows from market to banking channels.	reasonable equilibrium in the country's balance of payments.
June 24	Suspended limitations on the maximum rate of interest member banks may pay on single-maturity deposits of $100,000 or more that mature 30 days or more but less than 90 days after date of deposit.	To facilitate meeting any unusual demands upon commercial banks for short-term credit accommodation that might occur as a consequence of serious current uncertainties in financial markets.
Late July through mid-August	Directed that System open market operations be conducted with a view to maintaining bank reserves and money market conditions consistent with the objective of moderate growth in money and bank credit over the months ahead, allowing for a possible continued shift of credit flows from market to banking channels, with a provision for modification of operations as needed to counter excessive pressures on financial markets, should they develop.	To foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.
August 17	Reduced reserve requirements against time deposits in excess of $5 million at each member bank from 6 to 5 per cent and applied a 5 per cent reserve requirement on funds obtained by member banks through the issuance of commercial paper by their affiliates, both actions to become effective in the reserve computation period beginning October 1 and be applicable to such deposits and commercial paper outstanding in the week beginning September 17.	To maintain the effectiveness of the reserve requirements of Regulation D by applying those requirements to funds received by a member bank as the result of issuance of obligations (commonly described as commercial paper) by an affiliate, and to provide a net release of reserves to the banking system.

Principal Federal Reserve Policy Actions, 1970: Digest—Continued

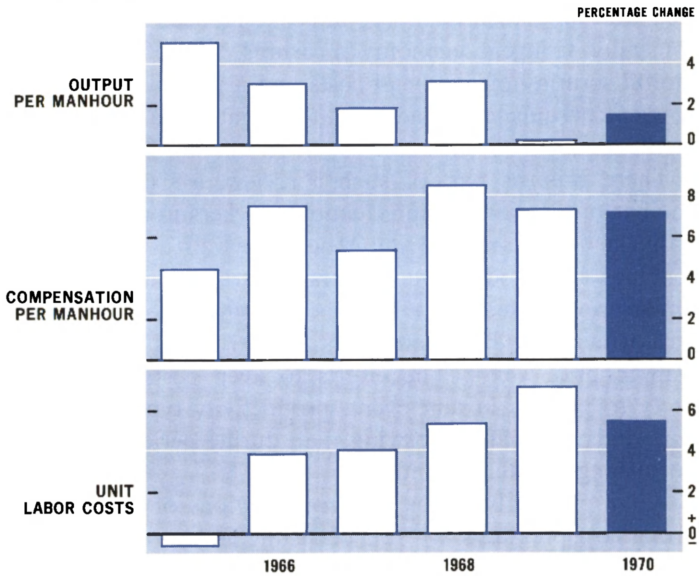
Period, or announcement date	*Action*	*Purpose*
Mid-August through mid-September	Directed that System open market operations be conducted with a view to maintaining bank reserves and money market conditions consistent with the objectives of some easing of conditions in credit markets and of somewhat greater growth in money over the months ahead than had occurred in the second quarter, taking account of possible liquidity problems and allowing bank credit growth to reflect any continued shift of credit flows from market to banking channels.	To foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.
Mid-September through mid-December	Directed that System open market operations be conducted with a view to maintaining bank reserves and money market conditions consistent with the objectives of some easing of conditions in credit markets and of moderate growth in money and attendant bank credit expansion over the months ahead, with allowance in the latter part of the period for temporary shifts in money and credit demands related to the auto strike.	To foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.
November 10	Reduced discount rates from 6 to 5¾ per cent at 6 Reserve Banks, effective November 11. (By No-	To bring the discount rate into better alignment with short-term in-

	vember 16, the 5¾ per cent rate was in effect at all Reserve Banks).	terest rates, in which reductions had recently taken place.
November 30	Amended rules governing member bank reserves (Regulation D) and foreign branches of member banks (Regulation M), effective January 7, 1971, to (1) raise from 10 to 20 per cent the reserve ratio applicable to a member bank's Euro-dollar borrowings to the extent that they exceed a specified reserve-free base and (2) apply an automatic downward adjustment feature to the minimum reserve-free bases applicable to Euro-dollar borrowings.	To give banks an added inducement to retain Euro-dollar borrowings in order to preserve reserve-free bases.
	Reduced discount rates from 5¾ to 5½ per cent at 5 Reserve Banks, effective December 1. (By December 11, the 5½ per cent rate was in effect at all Reserve Banks.)	To re-establish better alignment between the discount rate and short-term interest rates, in recognition of further downward movements that had recently taken place in the latter.
Mid-December through year-end	Directed that System open market operations be conducted with a view to maintaining the money market conditions recently attained, provided that the expected rates of growth in money and bank credit were at least being achieved.	To foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

manufacturing declined in 1970 to levels near the lows reached in the recessions of 1957-58 and 1960-61.

Nevertheless, some progress was made in 1970 toward moderating cost pressures. For the private economy as a whole, the rise in overall unit labor costs was smaller from the third quarter of 1969 to the third quarter of 1970 than over the preceding year—5.5 per cent as compared with 7 per cent. To avoid the distorting influence of the strike in the auto industry, Chart 4 shows changes between the third quarters of 1969 and 1970, rather than between fourth quarters as in preceding years. In the manufacturing sector, however, unit labor costs apparently increased more in 1970 than in 1969.

4. OUTPUT PER MANHOUR AND RELATED DATA



Bureau of Labor Statistics data for the total private economy. Changes are from fourth quarter to fourth quarter—except for 1970, which is from third to third.

The deceleration of the rise in unit labor costs in the private economy as a whole in 1970 was attributable to a resumption of productivity gains. After having shown little net change over 1969, output per manhour—accompanying gains in real output—rose appreciably in the second and third quarters of 1970; the annual rate of gain in these two periods averaged about 4 per cent. Productivity in manufacturing also improved in that period, although the gain in output per manhour was a little less for that sector of the economy. It is difficult to evaluate the extent to which progress may have continued in the fourth quarter because sharp cutbacks in output resulting from the auto strike distorted the aggregate productivity figures at that time.

The increase in productivity during the middle quarters of 1970 is somewhat atypical since the largest gains in output per manhour are usually achieved during periods of rapid growth in output. However, the increase in real GNP was quite small in the second and third quarters, and manufacturing output was declining. Nevertheless, productivity gains were achieved as the sluggishness of demands, coupled with continued advances in costs, induced management to adopt unusually stringent economy measures. These measures included a careful scrutiny of overhead costs and a paring of conventional management perquisites, in addition to an intensive review of labor force needs.

There was, as part of such a review, a sizable reduction in the number of salaried (nonproduction) workers in manufacturing—especially in defense-related industries—as well as a cyclical decline in demands for production workers. In trade, finance, and services a similar review seems to have been going on, since the increase in employment in these industries in 1970 was substantially smaller than in prior years. The efforts to keep costs under control seem likely to persist; in any event, productivity typically increases faster in periods of cyclical upswing than during periods of recession or of sluggish aggregate demands.

While productivity has shown indications of a faster rate of gain, strong cost pressures are still persisting as hourly labor compensation (which includes wages, salaries, and fringe benefits) has continued to increase rapidly for the private economy as a whole. But while the increase in hourly compensation from the third quarter of 1969 to the third quarter of 1970 was not much different from that over the preceding year, it was smaller than during 1968. In the manufacturing sector, however, the aggregate increase in hourly compensation during 1970 was larger than over the preceding year, even though the rise was held down by reduced overtime pay resulting from a shorter workweek and also by a shift away from the relatively high-pay durable goods industries.

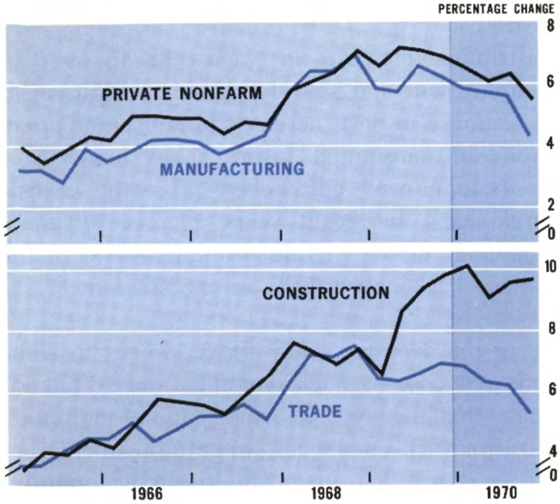
Large and widely distributed increases in wage rates in 1970 in the face of declining employment and sharply rising unemployment reflect in part a lagged response to past increases in consumer prices and in part expectations of substantial future price increases—expectations that have become well entrenched after the experience of the past several years. In recent years average advances in compensation per manhour in the private economy—and in the manufacturing sector—have been only a little in excess of increases in consumer prices.

Despite the behavior of the averages cited above, wages in some sectors have shown some response to slack demands and soft labor markets. Thus, it appears that the average wage gain of nonunion workers slowed in 1970. For such employees, wage adjustments are commonly made each year rather than in the multiyear negotiations that are typical of contracts involving unionized workers. In part because of this, wages in the nonunion sector appear to respond more quickly to cyclical changes in the demand for labor.

Nonunion workers are heavily concentrated in retail trade, finance, and other services. There was a marked slowing in 1970 in the advance of average hourly earnings in trade. On the other hand, the rise in average hourly earnings of construction workers remained exceptionally large—with year-over-year increases averaging 9 per cent in both 1969 and 1970. The substantial increase in earnings of this group reflects mainly the extraordinarily large increases for union workers. In manufacturing too, union workers received larger increases on the average in 1970 than did nonunion workers; furthermore, relatively more union than nonunion workers received wage increases—two-thirds as compared with only about one-third.

There has been a substantial escalation since 1968 in the size of wage increases negotiated in collective bargaining settlements—not only for first-year wage increases but also for the life of the contract. The increases provided in 1970 to cover the second and third contract years were well above the long-term trend of growth in productivity. Moreover, there has been some shift—after a lapse of many years—toward the incorporation in long-term contracts of escalator provisions based on the consumer price index and an insistence, as in

5. AVERAGE HOURLY EARNINGS



Change from corresponding quarter a year earlier, calculated from Bureau of Labor Statistics data, without seasonal adjustment.

recent contracts in the automobile industry, on an unlimited escalator. Since the amounts involved in such increases are, of course, unknown, they are not reflected in the data on the size of settlements negotiated. Relatively few workers are covered by escalator clauses; at the beginning of 1971 only about 3 million workers were covered by cost-of-living clauses providing for adjustments in wage rates tied to increases in the consumer price index.

In 1971 new wage agreements will be negotiated for nearly 5 million workers under major contracts in private nonfarm industries; this will make 1971 the second successive year of heavy collective bargaining activity. In the 1960's the largest number of workers covered by major contract settlements had been 4.6 million—in 1968. Moreover, in 1971 another 5.3 million workers already covered by multiyear contracts will receive deferred wage increases averaging 7.8 per cent—exclusive of cost-of-living increases—compared with an average deferred wage increase of 5.6 per cent in 1970.

The persistence of strong upward wage pressures raises questions concerning the extent to which market forces will moderate cost in-

TABLE 9: WAGE RATE ADJUSTMENTS IN MAJOR COLLECTIVE BARGAINING SETTLEMENTS

Mean percentage increases

Item	1968	1969	1970
All private nonfarm industries:			
Over life of contract	5.9	7.6	8.9
First year	7.4	9.2	11.9
2nd and 3rd year average	5.2	6.8	7.4
Manufacturing:			
Over life of contract	5.2	6.0	6.0
First year	7.0	7.9	8.1
2nd and 3rd year average	4.3	5.1	5.0
Construction:			
Over life of contract	8.6	13.1	14.7
First year	8.7	13.1	18.3
2nd and 3rd year average	8.5	13.1	12.9

NOTE.—BLS data. Major settlements are those affecting 1,000 workers or more.

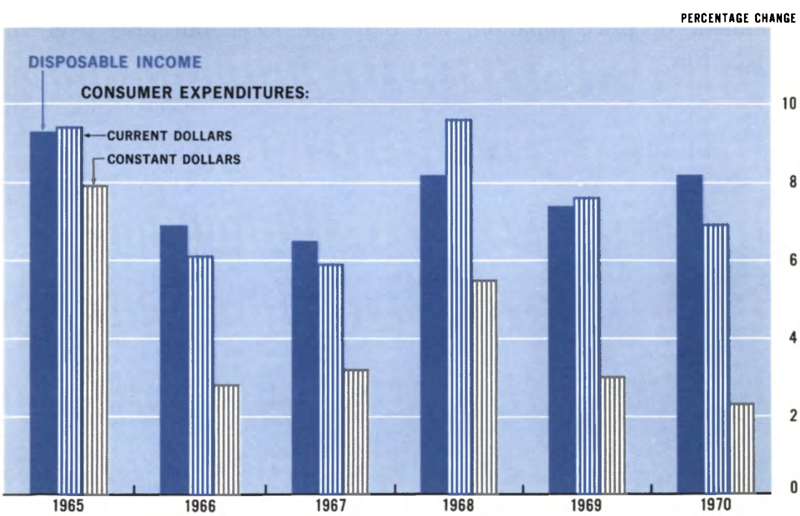
creases as economic recovery proceeds in 1971. It seems likely that some cost abatement will develop, in part as a result of the business economies already undertaken and in part because the widely anticipated upturn in aggregate output may be associated with gains in productivity that are more rapid than those in recent years. But the underlying strength of wage demands, if they persist well in excess of likely gains in productivity, would pose a major threat to the containment of price inflation, not only for 1971 but also over the longer run. □

Consumer Attitudes and Behavior

Consumers in 1970 slowed their rate of spending relative to income and shifted their savings toward more liquid forms, particularly deposits with banks and nonbank savings institutions. While declining yields on market securities were a major factor in the shift in the form of consumer financial saving, the emphasis on liquidity and risk-free assets was probably also an aspect of the development of more cautious attitudes on the part of consumers over the course of the year.

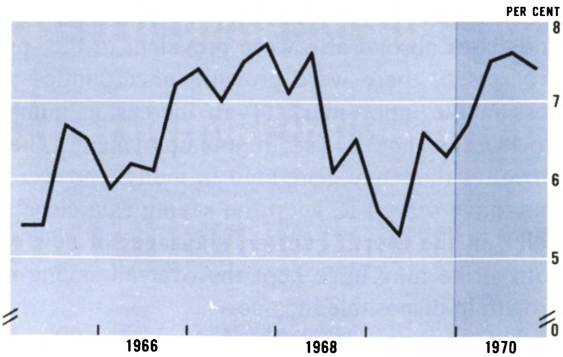
The bearishness of consumer sentiment in 1970 was indicated both by actual behavior and by various attitudinal surveys taken during the year. Two factors in particular—high and rising prices and job uncertainties—led to conservative spending behavior. In consequence, consumer spending increased less rapidly in 1970 than in the previous year, even though gains in disposable personal income had been relatively larger until the fourth quarter, when strike effects

6. CONSUMER INCOME AND EXPENDITURES



Change from fourth quarter to fourth quarter—except for 1970, which is from third to third—based on Dept. of Commerce data.

7. SAVING RATE



Dept. of Commerce data.

held down the income flow. In Chart 6, which shows changes in disposable income and consumer outlays, the changes for 1970 are measured from the third quarter of 1969 to the third quarter of 1970 in order to avoid the effects of the auto strike.

In current-dollar terms the percentage increase was less for consumer outlays than for income in 1970—in contrast to the previous 2 years. The slowed pace of consumer spending was even more marked in constant-dollar terms, as prices continued to rise rapidly.

As the advance in spending was curtailed, the rate of personal saving rose. For the year 1970 as a whole, the saving rate averaged 7.3 per cent, as compared with 6 per cent in 1969. The rate for 1970 was high in terms of experience in most years since World War II. In the past decade, that rate had been exceeded in only one calendar year—1967.

A number of influences contributed to the sharp increase in the saving rate in 1970. The sharpest jump occurred in the second quarter when the rise in disposable income was exceptionally large because of retroactive social security benefits and a retroactive Federal pay increase. A lag in adjusting spending to such a large and concentrated rise is to be expected, but other developments probably also contributed to the rise. Prices of common stocks broke sharply further in the early months of 1970, with the low reached in May. Both market participants who had suffered substantial losses and others who were concerned about what the break might mean for the economy probably curtailed their spending on this account.

Adding to these uncertainties in the spring were the widely publicized difficulties of some well-known corporations. Social tensions and crises abroad also were prevalent in the spring. Then as the year progressed, there were growing uncertainties associated with weakness in the labor market—an increasing number of layoffs, shorter workweeks, and a rise in unemployment. These, together with the anxieties that they generated in many who were not directly affected, may have served to keep the saving rate close to its spring peak. Finally, in the fourth quarter, shortages of new cars resulting from the auto strike may have kept the over-all saving rate up despite slower growth in disposable income.

A counterpart in 1970 of the high personal saving rate and the large dollar volume of personal saving was a very sharp increase in net financial investment by the consumer sector, as may be seen in the table. A similar spurt had occurred in 1967, when the saving rate also was relatively high.

The sharp increase in net financial investment in 1970—about double the 1969 pace—took the form partly of a larger flow of funds into financial assets, particularly interest-bearing deposit accounts. Much of the higher saving was also reflected in a lower rate of borrowing, the lowest in the past 5 years. Thus, the increase in outstanding consumer instalment credit was the smallest since 1961, and home mortgage debt, constrained by the high cost and earlier restricted availability of such funds, increased at a somewhat slower rate than in 1969.

TABLE 10: CONSUMER FINANCIAL INVESTMENT

In billions of dollars

Type	1966	1967	1968	1969	1970[1]
Net financial investment	25.6	37.0	24.2	20.3	44.4
Net acquisition of financial assets	49.3	60.7	58.9	50.3	66.7
Demand deposits and currency	3.1	11.4	6.9	3.4	4.7
Time deposits	19.1	32.5	27.7	11.3	31.4
Market instruments	11.9	−1.3	5.4	18.8	12.2
Net increase in liabilities	23.6	23.7	34.6	30.0	20.0
Consumer instalment credit	6.2	3.4	9.0	8.3	3.0
Mortgage debt	13.6	11.7	16.0	17.4	13.0
Other	3.8	8.6	9.6	4.3	4.0

[1] Preliminary.

NOTE.—Flow of funds data for households, personal trusts, and nonprofit organizations.

The extent to which consumer spending will rebound in 1971 is a critical question in appraising the likely speed of economic recovery. This will depend not only on the extent of future increases in personal disposable income, but also on the confidence with which consumers view the future. Certainly the improvement in financial positions, taking into account the sharp recovery in stock prices over recent months, should tend to make consumers more willing to increase spending and to reduce their rate of saving. Really vigorous support for the economy from consumption, however, probably must await progress in dampening fears that family budgets will continue to be pressed by rapidly rising prices for the goods and services that people must buy. □

Responsiveness of Housing and State and Local Governments

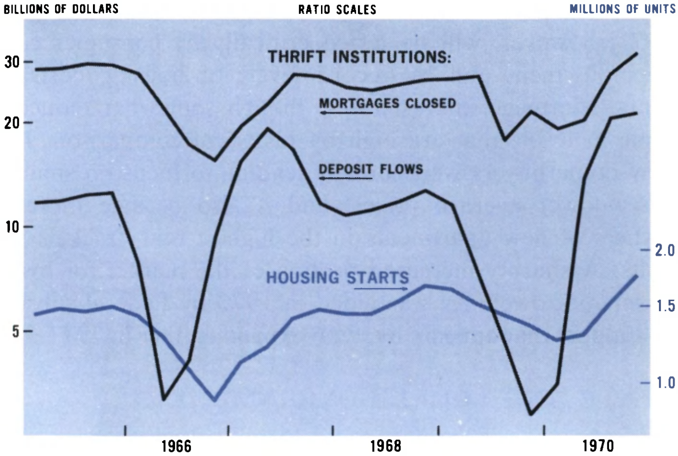
The more expansive monetary policy followed during 1970 led to a significant increase in flows of credit into markets for mortgages and for State and local government securities. Outlays for residential construction began to expand after midyear, and by the final quarter private housing starts had risen to the highest annual rate in 20 years. In contrast, construction expenditures by State and local government units had not increased appreciably by the close of 1970. Easier credit conditions, however, have led to heavy volumes of financing by such units. Under these circumstances construction contracts and actual outlays in this area are likely to increase in the months to come.

HOUSING

As noted earlier, deposit inflows to savings and loan associations and mutual savings banks increased sharply in 1970. By the fourth quarter these inflows had reached the highest rate since 1967 and were permitting the thrift institutions to rebuild their depleted liquidity positions and to increase their lending on both new and existing residential properties.

At the year-end the thrift institutions had accumulated a substantial backlog of mortgage commitments. Such a backlog pointed toward a continued, if not enlarged, flow of credit to the housing market. Other lenders—including commercial banks—also appeared to be showing more interest in residential mortgages, as yields on such loans were declining less sharply than returns on other types of capital market instruments, and hence were becoming relatively more attractive. In addition, weaknesses in business loan demands made more funds available to commercial banks for investment in mortgages.

8. THRIFT-INSTITUTION ACTIVITY; HOUSING STARTS



Quarterly averages of monthly data at seasonally adjusted annual rates. Thrift institutions include savings and loan associations and mutual savings banks (New York State banks only for mortgages closed).
Sources: S&Ls, Federal Home Loan Bank Board; savings banks, National Association of Mutual Savings Banks and Savings Banks Association of the State of New York; private farm and nonfarm housing starts, Bureau of the Census.

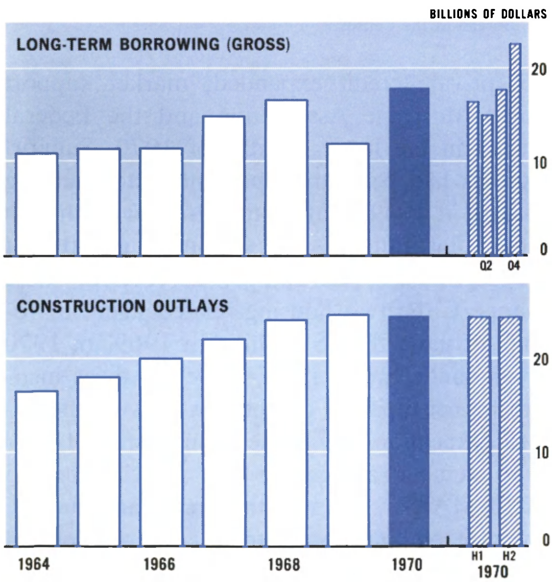
As the availability of private credit expanded, market support from the Federal National Mortgage Association and the Federal home loan banks slackened in the latter months of 1970. Support provided by these institutions had been an important factor limiting the decline in housing starts in 1969 relative to 1966, even though deposit growth at the thrift institutions—the dominant group that lends on residential mortgages—dropped sharply in each of these years. To finance this support, the two housing-related agencies together had borrowed a net of more than $7 billion in 1969. In 1970 they borrowed a similar amount. During 1971, however, these institutions are more likely to be net repayers of debt, in view of the expectation of some net repayment to the home loan banks of outstanding advances made to member savings and loan associations and of a reduced volume of FNMA purchases in the secondary market.

In early 1971 the low rate of housing vacancies, the accelerated pace of inflows of funds to thrift institutions, the high level of outstanding mortgage commitments, and the increased momentum in builder planning and activity all suggested that the pace of housing starts would continue at advanced levels. The demand for housing in 1971, however, will be tested critically by consumer concern about unemployment and by record levels of housing costs, prices, and rents. Mortgage interest rates, though somewhat reduced, also continue at levels that are high by historical comparison. During 1970, new home buyers were already tending to focus on smaller units that carry lower average prices, and it also became more difficult for owners of new apartments in the highest rent brackets to lease such units. A sharply increased portion of the market for lower-priced or lower-rent dwellings was aided in 1970 by Federal subsidies—a type of support that appears likely to expand further in 1971.

STATE AND LOCAL GOVERNMENTS

By the final months of 1970, gross long-term borrowing by State and local governments had risen to new highs. The increased volume of

9. STATE AND LOCAL GOVERNMENTS



All figures for 1970 are preliminary. Borrowings: from Investment Bankers Association; quarterly data, at annual rates not seasonally adjusted. Construction outlays: Bureau of the Census estimates; semiannual data, at annual rates seasonally adjusted.

such borrowing and the strong pace expected in 1971 reflect several factors.

In 1970 many State and local governments took advantage of declining interest rates—and record purchases of tax-exempt bonds by commercial banks—to market issues that had been postponed the previous year. In 1969, according to Federal Reserve surveys, the rapid increase of market interest rates had contributed directly and indirectly to the first year-to-year declines in gross long-term borrowing by State and local governments since 1960. In addition, many units had resorted to short-term financing to cover their most urgent needs in 1969 and early 1970 and were under pressure to issue long-term bonds as market interest rates declined in the second half of 1970. Moreover, the ability of State and local units to borrow had been improved since the fall of 1969, as the ceiling rates that many units could pay on their securities had been increased or temporarily suspended. Thus, by the end of 1970 many States and their subdivisions had a greater amount of flexibility to market new long-term bond issues, particularly in view of the fact that interest rates on such issues had declined substantially below their earlier peaks.

Construction outlays by State and local governments, which are financed in large part by borrowing, had increased at an average annual rate of more than 9 per cent from 1962 to 1968. The shortfall in their borrowing in 1969 restrained such expenditures, however, and these outlays rose little further even in current dollars. Despite the increased pace of borrowing in 1970, total outlays showed no significant change—and actually declined in real terms—because of the long lags between fund availability and expenditures. In view of the increased borrowing undertaken since mid-1970, however, it appears likely that construction outlays in 1971 will move back toward their earlier pattern of growth. Indeed, a period of unusual expansion in such outlays could well develop as shortfalls from previous capital budget plans are made up. □

Easing in Credit Availability at Banks

Deposit inflows to, and the availability of credit from, commercial banks improved progressively during 1970 as a result of the cumulative effects of the general easing in monetary policy, of bank regulatory changes, and of the broad decline in market rates of interest. Because inflows of deposit funds were strong and loan demands were relatively weak, banks reduced sharply their reliance on nondeposit sources of funds after midyear and restored severely depleted liquidity positions. In light of these developments, banks by the end of 1970 were in a considerably better position to meet the credit needs of an expanding economy.

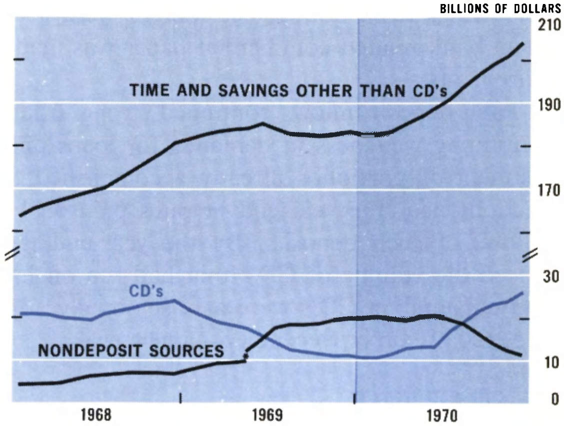
SOURCES OF FUNDS

Total deposits at banks rose sharply in 1970, in contrast to the decline during 1969 when monetary policy was quite restrictive. While demand deposits resumed their growth as market rates of interest declined and the public sought increased liquidity, the bulk of the increase in inflows at banks was attributable to the sharp rise in time and savings deposits.

Time and savings deposits other than large-denomination CD's—principally consumer-type time and savings deposits—grew rapidly after the first quarter of 1970. Banks generally raised the interest rates offered on these deposits shortly after the Board acted in January to liberalize ceiling rates under Regulation Q. Other authorities raised interest rate ceilings for savings and loan associations and mutual savings banks at the same time, and all three types of depositary institutions subsequently experienced increased rates of deposit inflow.

Growth in total time deposits surged after midyear when banks became able to compete aggressively for large CD's. Even though ceiling rates on large CD's had been raised in January, along with rates on other time and savings deposits, banks could sell only limited volumes of CD's because interest rates on competing money

10. INTEREST-BEARING SOURCES OF BANK FUNDS



Seasonally adjusted monthly averages of daily figures for all commercial banks. Time and savings deposits other than CD's exclude both those due to domestic commercial banks and the U.S. Govt. and balances accumulated for repayment of personal loans. Nondeposit sources include borrowings from foreign branches and * beginning June 1969, bank-related commercial paper, loan repurchase agreements, and borrowings from foreign banks and branches in U.S. territories and possessions.

market instruments remained significantly above the rates that banks were permitted to offer. Following the suspension of the Regulation Q ceilings on large 30- to 89-day CD's in late June, banks quickly raised their offering rates on short-term CD's to competitive levels.

As a result banks were able to increase their outstanding CD's by $4.9 billion during the month of July alone. There are indications that part of these CD's were acquired by investors who did not want to roll over their commercial paper in the wake of the substantial deterioration of confidence in such paper following the announced insolvency of a major railroad. In addition to CD inflows, banks during the summer used the Federal Reserve discount facility to meet unusual loan demands from customers who were unable to refund maturing issues in the commercial paper market.

But even after the pressures associated with the commercial paper crisis subsided, banks continued to issue large CD's in volume. They used a sizable portion of these inflows to restructure their liabilities, with particular emphasis on repaying higher-cost Euro-dollar borrowings and bank-related commercial paper. Many banks had relied heavily on such funds during 1969 and early 1970 to supplement the funds they acquired through normal deposit channels. Repayments of borrowings from nondeposit sources were accelerated in September, when bank-related commercial paper was made subject to reserve requirements.

Total deposit inflows continued strong in late 1970. In view of the continuing weakness in demands for loans and the substantial readjustment of portfolios already accomplished, banks made sharp reductions near the year-end in rates paid on large CD's to moderate inflows of such deposits. By the year-end they had more than replaced the volume of CD's that had run off in 1969 and early 1970, and outstanding CD's were at a seasonally adjusted monthly average of $26.0 billion in December—a new peak.

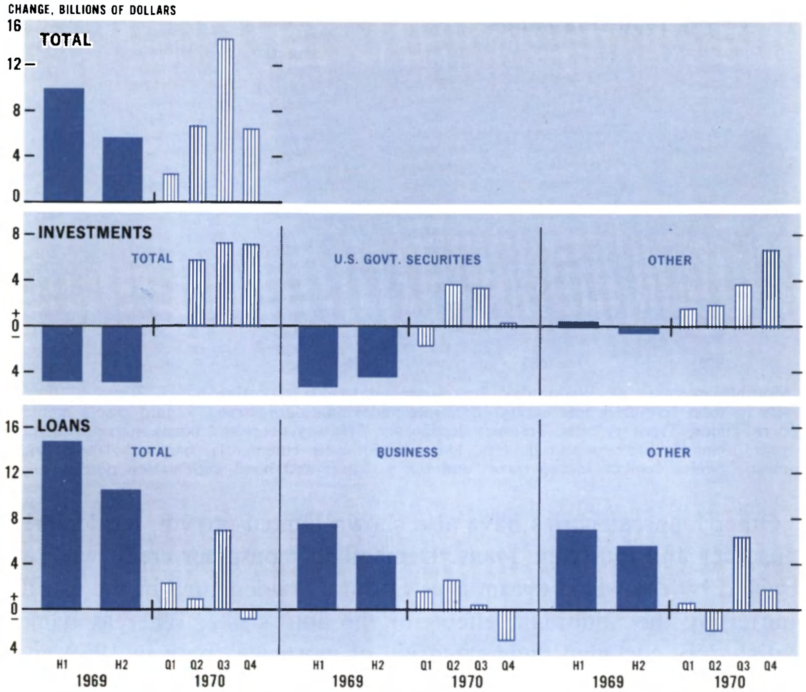
BANK CREDIT

Bank credit developments in 1970 and early 1971 have reflected principally the marked increase in fund availability and the lessening of loan demands. Total loans and investments at all commercial banks, including loans sold to bank affiliates or subsidiaries, increased by $30 billion in 1970, or nearly twice the increase over the preceding year. A substantial portion of this growth represented bank acquisitions of securities, which had registered a considerable decline in 1969.

Participating heavily in U.S. Treasury financing operations, banks acquired a net of more than $7 billion, seasonally adjusted, of U.S. Government securities during the middle two quarters of 1970. And throughout the year they increased sharply the rate of acquisition of other securities—principally State and local government obligations—after having maintained their holdings of such securities virtually unchanged in 1969. In large measure, banks concentrated on acquiring shorter-term investments so as to restore their depleted liquidity positions. The large rise in liquid assets along with concerted efforts to reduce reliance on borrowed funds resulted in an appreciable improvement in over-all bank liquidity and contributed significantly to banks' willingness to extend a larger volume of loans.

Although the substantial rebuilding of liquidity was in large part desired, it also reflected the general weakness in demand for loans. Total loans at all commercial banks, including loans held by affiliates

11. BANK CREDIT, 1969-70

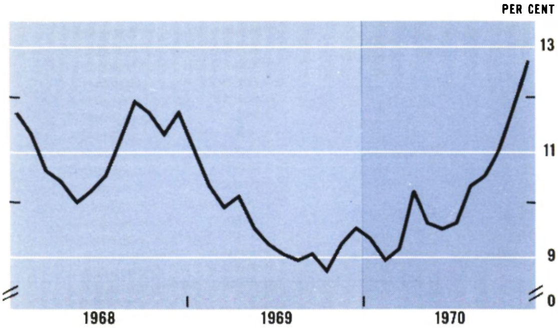


Seasonally adjusted data for all commercial banks. Beginning June 1969, loan items have been adjusted to include loans sold to bank affiliates, subsidiaries, holding companies, and foreign branches.

and subsidiaries, grew slowly in the first half of 1970, then rose by $7 billion in the third quarter. During the latter period banks extended a large volume of credit to securities dealers as well as to finance companies and other borrowers experiencing difficulty in the commerical paper market. But in the fourth quarter loans at commercial banks declined on a seasonally adjusted basis.

The reduction in loans at banks in the fall reflected the general weakness in economic activity and the associated decline in credit requirements, together with the effects of the auto strike in the fourth quarter. In addition, banks have experienced substantial business loan repayments out of the proceeds of capital market financings as corporations placed considerable emphasis on lengthening their debt structure and improving liquidity positions.

12. LIQUIDITY RATIO
Weekly reporting banks



Monthly averages of Wednesday figures for all weekly reporting banks. Ratio of liquid assets to total liabilities less capital accounts and valuation reserves. Liquid assets include Federal funds, Treasury bills, Treasury certificates, Treasury notes and bonds maturing within 1 year, loans to brokers and dealers, loans to domestic commercial banks, balances with domestic banks, bankers acceptances, and tax warrants and bond anticipation notes.

Other loan categories have also shown limited growth, particularly consumer and mortgage loans. Demand for consumer credit was restrained by the weakness in sales of durable goods and in the fourth quarter by the additional effects of the auto strike. Whereas banks had sharply curtailed their extension of mortgage credit in 1969 and early 1970, when their fund inflows were constrained, since the autumn they have indicated an increased willingness to extend mortgage credit. The increase in mortgage loan portfolios did not pick up appreciably until late in the year, but this appears to reflect the long lags between mortgage commitments and the actual takedown of funds.

These changes in bank asset positions were an important factor in the decline in the prime rate of interest from 8½ per cent in early 1970 to 6 per cent in January 1971. Other loan terms and conditions also have been eased, and banks are now more willing to undertake loan commitments that they would not have made earlier, including extensions of term loans to business. However, with concern over the quality of loan portfolios heightened by the well-publicized difficulties of several major firms, banks reportedly are continuing to emphasize quality standards. □

Adjustments in the Business Sector

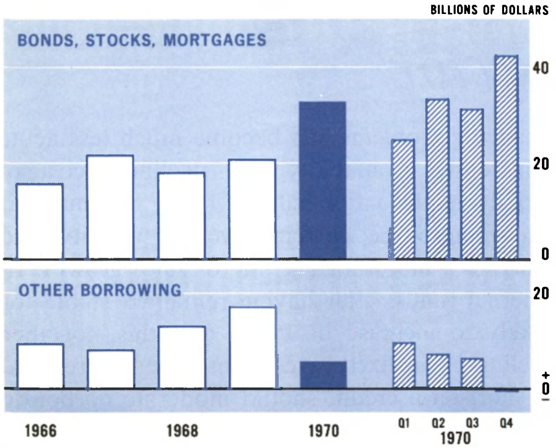
In the business area, financing problems had become much less acute by early 1971. The increased availability and declining cost of short-term credit, especially in the latter half of 1970, has made it easier for businesses to finance the current level of activity and should facilitate the return to a more normal rate of sales growth. In addition, the flow of internal funds, after having remained stable for several years, seems likely to increase in 1971, and this, together with the anticipated leveling off in fixed investment expenditures and the improved access to short-term credit, should moderate corporate needs for capital market funds.

During 1970, in contrast, corporate financing operations in money and capital markets were characterized by a large increase in new issues of long-term securities and by greatly reduced financing in shorter-term markets. This pattern reflected several factors: the continued sharp rise in spending for plant and equipment by certain industries, the slow growth in current sales, and the funding of a portion of the large volume of short-term debt incurred in 1969.

In the closing months of 1970 business corporations floated a record volume of long-term securities while apparently repaying short-term debt on balance. Much of the year-end weakness in business demand for short-term credit, however, was attributable to the continued influence of the auto strike. But by early 1971 the situation had changed considerably: The auto strike was over; plant and equipment expenditures were expected to show little or no further rise, but it seemed likely that inventory accumulation would resume; and there would probably be some improvement in the flow of internal funds, in part because of the revised depreciation schedules that became effective in early 1971.

Hence there should be increased needs for—and greater availability of—short-term credit and some reduction in corporate demands on long-term capital markets in 1971. Some corporations may still wish to lengthen the maturity of their debt or otherwise improve their liquidity positions. But pressures to do so have subsided since

13. CORPORATE EXTERNAL FINANCING



Flow of funds data for nonfinancial corporations. Quarterly data seasonally adjusted at annual rates. "Other borrowing" comprises bank loans n.e.c., open market paper, and other loans. Q4 1970 preliminary.

the easing of monetary policy has made renewal of maturing short-term debt more manageable and additional liquidity more readily available.

BUSINESS INVESTMENT

As of early 1971 business firms in the aggregate were planning almost no increase in spending for fixed assets during the year. This weakness reflects mainly developments in manufacturing. With their margin of unused capacity at the highest average level since early 1958, and with their profits greatly reduced, manufacturers were planning reductions in capital outlays in 1971 for the second consecutive year. In the public utility and communications sectors, on the other hand, present capacity is inadequate to meet demands efficiently, and as in 1970 a further substantial increase in capital expenditures is scheduled for 1971. Since public utility and communications companies finance a large part of their capital outlays with the proceeds of new bond and stock issues, the increased expenditures they have planned for 1971 are likely to be reflected in heavier corporate demands on long-term securities markets than would otherwise be suggested by the expected minimal growth in over-all business fixed investment.

Inventory accumulation (GNP basis) by nonfarm businesses declined in 1970 to the lowest rate since 1961. Weakness in the growth of final sales appears to have been a primary factor in the cutback, but other influences also contributed to the reduced rate. These included the depletion of auto stocks in the fall as a result of the strike, reluctance to incur additional short-term debt, the desire to conserve available funds for more pressing needs and, as the year progressed, some waning of inflationary expectations. Nevertheless, reflecting to a considerable extent the sluggishness in sales, inventory/sales ratios remained high by historical standards.

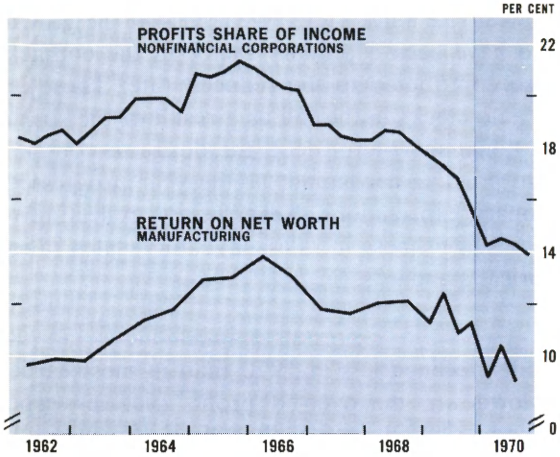
INTERNAL FUNDS

Although corporate profits declined less in 1970 than in most earlier periods of economic slowdown, the over-all profits picture—especially with respect to undistributed profits—has been exceptionally weak for some time. The profits share of income originating in nonfinancial corporate business has declined almost steadily in recent years, from 20 per cent or more in 1965 and 1966 to 14 per cent in 1970. Profits retained after payment of taxes and dividends have declined more than 50 per cent since 1966. Offsetting this decline has been a continued growth in capital consumption allowances. As a result, the total volume of internal funds has been static for several years.

Weakness in profits has been evident particularly in the manufacturing sector where both the ratio of profits to sales and the rate of return on net worth have declined to levels near the lowest since World War II. The erosion in profit margins has paralleled the decline in the capacity utilization rate, and if one judges from past experience, profit margins are not likely to rise to any significant extent until the utilization rate also rises sharply.

Nevertheless, trends within 1970 suggest a strengthening in profits and internal funds that should carry over into 1971. Abstracting the adverse developments in the fourth quarter because of the auto strike, the decline in profit margins slowed as the year progressed, reflecting efforts to reduce expenses and the faster growth in productivity; the share of profits in income, as well as total corporate profits before taxes (and before inventory profits), changed little after the first quarter; and total internal funds rose throughout the year from their first-quarter low. With somewhat faster growth in sales volume,

14. CORPORATE PROFITS



Quarterly except 1962–68 return on net worth, which is semiannual. Share of income: ratio of profits (before tax) and inventory valuation adjustment to income originating in nonfinancial corporate business, which is sum of profits, compensation of employees, and net interest paid; based on Dept. of Commerce seasonally adjusted data. Return on net worth: ratio of profits after tax, at annual rate, to stockholders' equity; not seasonally adjusted; source, FTC-SEC Quarterly Financial Report for Manufacturing Corporations.

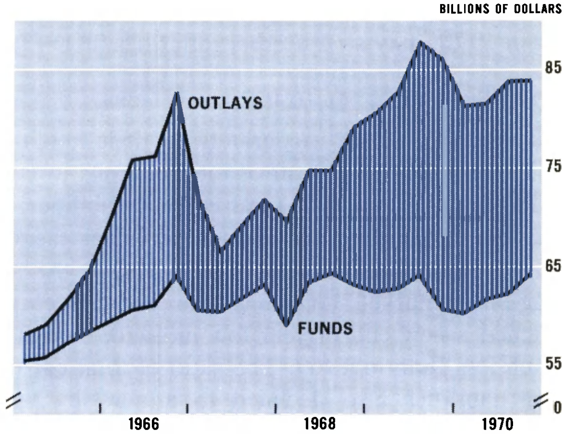
and especially with the recent liberalization in depreciation schedules for tax purposes, the flow of internal funds to nonfinancial corporations in 1971 may show the first significant increase since 1966.

EXTERNAL FINANCING

The failure of internal funds to grow in the face of a continued rise in spending for additions to fixed and working assets during recent years has required increased reliance by nonfinancial corporations on external sources of funds. In 1970 these businesses financed about 35 per cent of their total spending with funds raised in money and capital markets. This was the same as the record proportion in 1969, but the composition was quite different. Long-term financing in capital markets was three-fifths again as large as in 1969, whereas borrowing in short-term forms was the least since 1964.

The sharply reduced volume of borrowing by corporations from banks and other short-term lenders in 1970 reflected only in part the lower rate of inventory accumulation and the direct and indirect effects of the auto strike in the fourth quarter. An equally important

15. CAPITAL OUTLAYS AND INTERNAL FUNDS



Flow of funds data for nonfinancial corporations, seasonally adjusted at annual rates. "Outlays" comprise plant and equipment expenditures and change in inventories. "Funds" are sum of capital consumption allowances and undistributed profits, which are after inventory valuation adjustment and inclusion of foreign branch profits. Q4 1970 preliminary.

factor was the desire to limit further expansion of short-term debt, following the exceptionally large growth in such debt in 1969, and to lighten the pressure of frequent maturities by repaying short-term debt to the extent feasible.

Business demand for short-term credit remained weak through 1970. But the increased supply of such funds at declining cost, together with the return of confidence in financial markets, should result in a strengthening of credit demands in this area as sales prospects improve and inventory policies become more expansive.

Demands for long-term external funds, on the other hand, seem likely to moderate somewhat although remaining large by historical standards. A large share of the increase in long-term financing by corporations in 1970 reflected the expanded needs of public utility and communications companies, which rely heavily on such funds to finance plant and equipment outlays, and which will need to sell a substantial volume of security issues in 1971 too. But offerings by manufacturing corporations may be below the unusually large 1970 volume. Real estate investment trusts, whose offerings helped to swell the volume of new stock issues in 1970 to the largest total in many years, may also do less financing in 1971 in view of the increasing availability of conventional mortgage financing. On the other hand, financial corporations, which did little long-term financing in 1970, may step up their offerings in 1971.

CORPORATE LIQUIDITY

Corporations added moderately to their holdings of liquid assets in 1970, largely in the form of time deposits at commercial banks. The ratio of liquid assets to total current liabilities rose somewhat in the fourth quarter, but not enough to offset the declines that had occurred earlier in the year. Thus, despite the switch from short- to long-term market financing, the over-all corporate liquidity ratio reached a new end-of-year low in 1970, though the deterioration was much less than in 1969. The ratio of total current assets to total current liabilities also declined to a new low, primarily because the slowdown in economic activity resulted in an even slower growth in accounts receivable than in total current liabilities. □

U.S. Balance of Payments

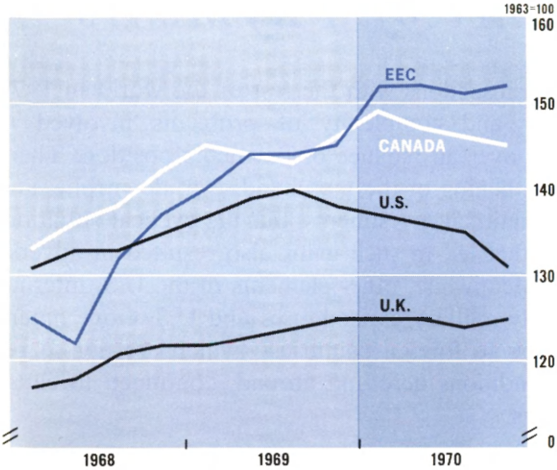
Developments in U.S. transactions with the rest of the world in 1970 illustrated the tenacity and complexity of problems involved in achieving a satisfactory over-all balance of payments position. There was indeed some strengthening of the merchandise trade surplus and of net receipts on international investments, but the cyclical situation, both here and abroad, that led to such gains also resulted in adverse shifts in capital flows. Meanwhile, other elements in the U.S. international accounts—notably military expenditures and U.S. Government aid and private transfers to foreign countries—which are not so responsive to business conditions here and abroad, continued to cause a large outflow of dollars.

MERCHANDISE TRADE

Events in 1970 underline the extent to which the traditional U.S. trade surplus had weakened during the period of excess domestic demand in the latter half of the 1960's and also show the sensitivity of trade flows to economic conditions in other industrial countries. Studies of the effects on U.S. trade of the demand inflation of the late 1960's, which followed an extended period of relative price stability, suggest that a large part—perhaps most—of the deterioration in the trade balance from its 1964 peak was associated with strong and sustained upward pressures on prices and wages in U.S. markets. The adverse effects of such developments in the international competitive position of U.S. industry can be overcome only with the passage of time.

In 1970 the U.S. trade balance with other countries responded well through midyear to the slowing of domestic demand and to the strong growth of demand in most other industrial countries. For most of the year policy in most countries was directed toward reducing inflationary pressures, and only as the year ended—with production in many industrialized countries flattening out—was attention abroad shifting to the problem of averting a general slowdown in economic growth. This course of events was reflected in the U.S. trade performance—leading to some erosion of the gains made in the first half of the year as foreign demands weakened.

16. INDUSTRIAL PRODUCTION



Seasonally adjusted OECD quarterly data.

U.S. exports in 1970 benefited from record shipments of agricultural products and a spurt in exports of large jet aircraft. The major support for foreign sales, however, was the demand in industrial countries for machinery and industrial materials. Even so, as the year progressed, and some slack developed in supply capabilities abroad, demand for these products decreased. New orders for machinery tended to level off, and easier supply conditions for steel abroad not only reduced U.S. exports but also supported a renewed surge of shipments from Europe and Japan to the United States.

The level of U.S. imports tended upward during the year, but it appears that perhaps three-quarters of the rise was accounted for by higher prices of imports. In the last quarter of the year, even though there was a decline in real economic activity, imports rose somewhat, reflecting especially strong demand for foreign steel, automobiles, and petroleum.

These trends indicate the difficulty of restoring a reasonable trade balance after a long period of domestic inflation, especially when growth rates and domestic demands in countries abroad are slowing. There were, however, some favorable indications in 1970 for the future of the trade balance. Import prices rose more rapidly than U.S. export prices, and while this factor may reduce the trade surplus in current-dollar terms over the short run, over the longer run it may benefit the trade position as the relative advantage of foreign goods is diminished. With improved economic performance in the United States and resumption of stronger economic growth rates abroad, the U.S. trade balance should make further gains over time.

CAPITAL FLOWS

Flows of capital between the United States and foreign countries also respond to the cyclical situation. Indeed, the response may be so large and rapid as to overmatch changes in the current account. This is increasingly true of the immense stock of mobile funds that respond quickly to changes in interest rate levels in the important monetary centers, utilizing the convenient mechanism of the Euro-dollar market. Such flows of funds complicate the management of monetary policy and result in sudden, large shifts of international reserves (largely dollar holdings) among central banks.

In 1970 the need for the United States to pursue a relatively expansionary monetary policy, while other countries did not move in that direction until the closing months of the year, led to a return flow to foreign commercial banks of some $6 billion of funds borrowed earlier by U.S. banks. This flow helped to restore needed reserves to some countries—notably the United Kingdom and France—and added to the reserve gains of other countries with continued strong basic positions—notably Germany.

These flows of liquid funds were not inspired—as were those of other recent years—by financial crises and currency speculation, but rather by market considerations. Under present-day conditions, when investors and borrowers are free to seek the most advantageous market, such flows respond readily to changing interest differentials among countries. These flows tend to be reversible as interest rate relationships change, and they do not have the same significance for the balance of payments as more deep-seated shifts in other transactions affecting reserves. A large part of the Euro-dollar reflows in 1970 represented a readjustment of the U.S. domestic banking system to its renewed regulatory and economic ability to compete for funds in domestic money markets. As noted earlier, the Federal Reserve took steps to moderate the rate at which U.S. banks were repaying their borrowings, in order to help offset the unsettling effect that might occur if large reflows continued over a short period.

Longer-term capital flows are also highly responsive to variations in economic activity here and abroad, and also to corresponding variations in the cost of funds. The outflow of U.S. funds in response to such variations remains inhibited by Government restraints, which have been retained in 1971 because of the persistence of large deficits in the U.S. balance of payments. U.S. industrial firms have indicated that they plan to carry out major programs to expand their foreign productive facilities in 1971. With domestic demand for loans relatively weak, it is to be expected that U.S. banks would wish to enlarge their foreign credits if there were no guidelines concerning foreign credit restraint. Though there was some increase in the outflow of capital for these purposes in 1970, it was probably much less than would have occurred without the restraint programs. In the case of U.S. purchases of foreign securities, the outflows were smaller than in other recent years, in part because of the restraints but also because Canadian borrowers made more use of their own capital markets.

The principal change in flows of foreign capital in response to changes in the economic situation—apart from flows of liquid funds—was in transactions in U.S. equity securities. Foreign investors shifted from net sales of $0.2 billion in the first half to net purchases of $0.8 billion in the second half, once the U.S. equity market began to show basic strength again.

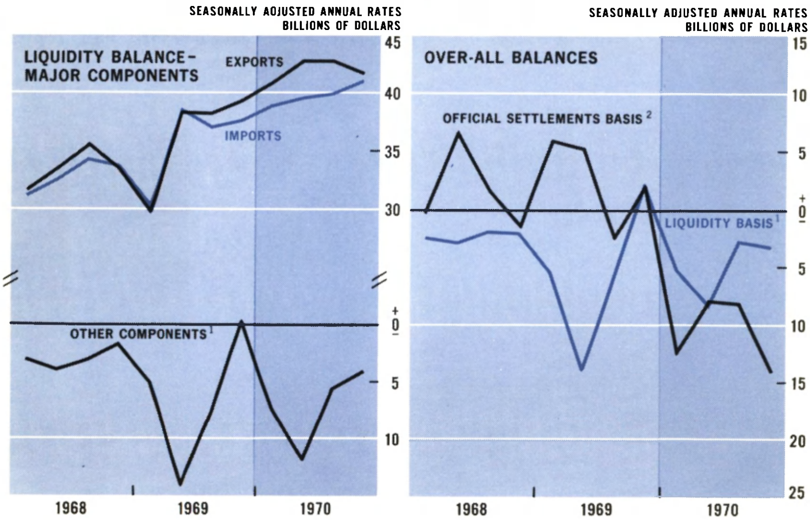
Taking U.S. and foreign private long-term investments together, there appears to have been a net increase in outflows of some $1.5 billion from 1969 to 1970. Of course, the adverse shift in flows of short-term funds was much greater. Looking ahead, it seems likely that the outflow of U.S. private capital will continue to be large in 1971, though the amount will be limited by the restraint programs. However, with recovery in the U.S. economy, some increase in the inflow of funds for investment in corporate securities would be expected. Also, there is much less scope for return flows of borrowed private foreign short-term funds, after the attrition of 1970.

OVER-ALL BALANCE

The net result of divergent changes in the U.S. trade and capital accounts in 1970 was a moderate improvement in the liquidity balance

—apart from special transactions and the initial allocation of SDR's. Over the years there has been a tendency for the current and capital accounts of the U.S. balance of payments to move in opposite directions, as the cyclical conditions favoring improvement in the current account have, at the same time, tended to encourage net capital outflows. Given the large dollar outflows that are not related to economic conditions, large liquidity deficits tend to persist. From another point of view, the desire of foreign governments and private holders of assets to add to their liquid reserves, with the dollar a principal vehicle for doing so, is a factor in the continuation of U.S. balance of payments deficits.

17. U.S. BALANCE OF PAYMENTS



[1] Excludes special transactions with foreign governments and the SDR allocation.
[2] Excludes SDR allocation.

The U.S. balance of payments reflects a great diversity of economic and political decisions here and abroad—a diversity that is unique because of the pivotal role of the dollar in the world's monetary system. The large flow of dollars into foreign official accounts in 1970 was accommodated with relative smoothness, though not without concern that the continuation of such flows would disrupt the progress being made toward an improved monetary system. Contributing to generally calm foreign exchange markets in 1970 were the exchange rate adjustments accomplished in 1969, increased consultation and cooperation among national authorities, and the introduction of SDR's. □